The Institute of
Internal Auditors
Te Kaiarotake Matua o Aotearoa
New Zealand

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NZX Limited

Attention: Kristin Brandon

Email: policy@nzx.com

Kia ora Kristin

Submission on NZX Corporate Governance Code Review

The Institute of Internal Auditors (IIA) appreciates the opportunity to comment on NZX's review of its Corporate Governance Code (the NZX Code) as outlined in its draft exposure document.

Summary of IIA submission

The IIA welcomes the review of the NZX Code to ensure it is current, effective for good corporate governance reporting and aligned with good practice. This is the first time that the IIA has been able to provide input to the Corporate Governance Code and we look forward to being able to participate in future revisions, as this is a critical reference information for good governance in New Zealand. We are a small professional services membership organisation with limited resources, although we are keen to add value to corporate governance frameworks, as we view that an internal audit function is instrumental to, and a key pillar of good governance.

Overall, the IIA supports the review and the proposed areas of reform. Our submission pertains to certain sections included in the draft exposure document:

- The IIA supports the 'comply or explain' approach to implementing the Code. It's important to keep the Code as simple as possible to ensure that it remains effective as a way of encouraging greater uptake of governance good practice amongst listed companies. The Code's recommendations should drive strategic thinking and change within organisations while providing meaningful disclosure to owners and stakeholders. Self-regulation is a desired approach for New Zealand but must be accompanied by effective governance practices, including internal audit and risk management to provide assurance and stakeholder confidence.
- There are three Principles in the Code that we have provided commentary for your consideration. Specifically, these relate to Principles 3, 6 and 7: Board Committees, Risk Management and Auditors. We have made some suggestions for your consideration for improved guidance in these areas.

- The reporting requirements should align with other codes and practices issued by standard-setters and regulators and professional governance bodies like the Institute of Directors (IoD). The IIA regularly works with the IoD and has made good progress n obtaining their approval for input to their guidance documentation. There are several good practice guidelines that are included in the IoD's "The *Four Pillars of Governance Best Practice for New Zealand Directors".* For example, the sections on Audit Committees, Risk Management and Internal Audit could be reviewed for consideration of input to the Code. In addition, the External Reporting Board (XRB) is promulgating climate disclosure standards. We are providing input to the XRB on assurance requirements for these standards and encourage NZX to work closely with the XRB to ensure NZX guidance is consistent and aligned with the work the XRB is doing.
- The IIA supports the recently established of NZX Corporate Governance Institute. We note that in other jurisdictions (including Australia) that the IIA is a member of the Governance Institute. We would welcome the opportunity to contribute to the NZ Institute, including contributing risk, assurance, and governance expertise, as well as being a conduit for the IIA's members.

About the Institute of Internal Auditors

The Institute of Internal Auditors New Zealand (IIA NZ) is an affiliate of IIA Inc, Global. We are a member-led professional organisation that draws on the skills and knowledge of our over 750 members in the private and public sectors across the country. We've been established in New Zealand since 1986.

We're affiliated with and draw on the International Professional Practices Framework, including International Standards, a Code of Ethics, and globally recognised post graduate certification as well as extensive guidance, white papers, and resources of the IIA's global Institute. There are 170 affiliates and chapters, in 110 countries, with over 200,000 members worldwide, and one of the few Professional bodies to have such a global reach.

What do Internal Auditors do?

Internal audit is an independent, objective assurance and consulting activity designed to add value in seeking to improve the efficiency and effectiveness of the organisation's operations. It helps an organisation accomplish its objectives by bringing a systematic, disciplined approach to evaluate and improve the effectiveness of risk management, the control environment and governance processes.

Internal audit professionals are widely recognised, respected, trusted, and valued as the leading providers of assurance and advice on risk management, internal control, and governance for the benefit of organisations and their stakeholders.

Overview of NZX's Corporate Governance Code Review

The overarching purpose of the NZX Corporate Governance Code (the **NZX Code**) is to promote good corporate governance, recognising that boards are in place to protect the interests of shareholders and to provide long-term value. The NZX Code is the primary guidance on corporate governance for NZX-listed issuers.

NZX's Listing Rules require issuers to publicly report the extent to which the issuer has followed the recommendations set out in the Code on a 'comply or explain' basis.

The initial discussion document sought feedback in relation to the scope of the matters that NZX has identified for inclusion in the review, which was used as a basis from which to develop these more detailed proposals. NZX indicated it would be sample testing issuers' disclosure practices in relation to the Code and we would be interested in reviewing those insights.

A particular 'comply or explain' requirement relating to internal audit will be included in our commentary on Principle 7: Auditors.

IIA commentary

General comments and specific comments

The IIA welcomes the NZX's initiative to revise the NZX Corporate Governance Code to ensure it is fit for purpose, and up to date with developments and trends in corporate governance, both domestically and internationally.

Principle 3: Board Committees

Of particular interest to the IIA is the commentary and recommendations that relate to Audit Committees (3.1, 3.2).

The difficulty with guidance/requirements for Audit Committees is that strictly speaking they are only mandated to cover financial risk/financial reporting. Even in that limited role, the role of additional assurance to supplement what the external auditors must do is critical to ensure financial risks are appropriately governed and managed. There is limited reference to the oversight of the internal control environment in the Code. To discharge their accountability, Boards / Audit Committees need to obtain sufficient and effective operational assurance. This is further complicated as (I would suggest) most organisations have moved beyond financial risks to cover non-financial risks and at the very least compliance and regulatory requirements, e.g., those relating to cyber security, data protection, employee wellbeing and workplace safety. This is not part of the NZX Code – but could usefully be included to provide good practice for governors. Given the focus of external audit is retrospective over past financial performance and given the constraint that their opinions are based on materiality, operational assurance over key areas, such as those mentioned above, does have a significant positive impact on a company's future viability (brand damage) and financial security and in discharging their accountabilities. These are areas where Boards / Audit Committees require independent assurance.

It is worthy of note that the NZX significantly downplays the value of the role that internal audit can have in relation to an organisation's governance and specifically in its Audit Committee structure in the Code. The following is a quote from CPA Canada (endorsed by the Canadian Institute of Corporate Directors) in its professional development course offering:

"Overseeing the audit function, both internal and external, is a key responsibility for audit committees. Audit committee members must be able to confirm that auditing responsibilities are being carried out correctly."

Specifically, Recommendation 3.2 commentary includes: Employees should only attend audit committee meetings by invitation so as to protect the independence of the audit committee from undue influence.

While this is technically appropriate, it fails to recognise the unique role that auditors play. External auditors are not employees of the organisation and although internal auditors are employees their role is structured to be independent and objective through a structured independent reporting line to the board (via the chair of the Audit Committee). The attendance at Audit Committee meetings by external and internal auditors who act as trusted advisors is a necessary component of good governance in assisting the Audit Committee to work effectively. This approach is reflected in the following references from the ASX Governance Code and the IoD guidance where the unique role of internal audit is recognised.

The ASX includes in Recommendation 4.1 that one of the roles of the audit committee if there is an internal audit function is to review:

- – the appointment or removal of the head of internal audit;
- – the scope and adequacy of the internal audit work plan; and
- – the independence, objectivity and performance of the internal audit function.

The IoD's more specific guidance includes:

> *Four Pillars of Governance Best Practice for New Zealand Directors* - 4.9.4 Role of internal audit
> Internal audit supports the board to accomplish its purposes through an organised approach to evaluating the efficacy of internal controls, risk management and corporate governance. It is best practice for an internal audit function to report directly to the audit committee of the board to ensure independence. It is important to have clear lines of communication between the audit committee chair and the internal audit function manager. An audit committee often monitors management's implementation of internal audit report recommendations.

Principle 6: Risk Management

One of the primary focus areas for internal audit's role is to bring a systematic, disciplined approach to evaluate and improve the effectiveness of risk management.

The board's role in risk management is instrumental in achieving good governance. This would appear to be underdeveloped in the Code although components are included in the Commentary in 6.2. The ASX Code and the IoD guidance include some additional helpful references to good practice in this area as follows:

- Further expanding the board's role in risk management – it is a critical board function, overseeing and monitoring the risk management framework and processes by seeking assurance from management and other independent sources
- Ensuring that the board sets, regularly reviews and monitors the risk management framework including the risk appetite agreed by the board
- Obtain assurance from internal audit or other independent assurance providers on the adequacy of the company's processes for managing risk
- Request and then consider reports from management on new and emerging sources of risk. Monitor and assess the risk management measures put in place to deal with risks.

Sound risk management practices assessing the appropriateness of competing future opportunities and providing early warning to potentially significant issues are critical for future sustainability and a key accountability for the Board.

<u>Principle 7: Auditors</u>

There are exactly three references in the entire NZX code to Internal Audit on pages 19, 20 and 34. Pages 19 and 20 are part of the "Board Committees" Principle 2 already commented above under Audit Committees.

Principle 7 – Auditors: Includes the only reference (page 34) to internal audit to a requirement to state whether the organisation has an internal audit function and if not, why not. The focus on external audit in this section means that there is no understanding or guidance given in relation to assurance roles generally and internal audit specifically– and their importance to a well governed organisation. Organisations have moved well past the sole focus on financial soundness and even the balanced scorecard, which at least included resources, operations, and customers. The remit of internal audit includes providing assurance over current strategic outcomes and future focused areas, such as long-term projects to address climate change and ESG requirements. Financial risks are critical but so are non-financial risks and they are not included in the same way in the Code. While this section refers to "Auditors", the guidance is mostly around external audit and no other critical assurance that boards will certainly need to rely on if they are appropriately governing. In our experience, unfortunately the roles of external audit and internal audit are not well understood – and this includes by board directors who arguably have the most to gain through using this objective assurance function to support their governance role.

We're supportive of additional requirements, like those the IoD includes in Section 3.5 of its 4 Pillars guidance:

- Internal audit supports the board and management with objective assurance about internal controls and risk management and helps underpin strong corporate governance.
- It is a valuable resource for directors having to deal with multiple forms of risk.

An example relates to Principle 1 on Ethical Standards. While the Principle outlines why a standard is important and what the board's role is in setting and modelling the standard, it does not note the board's monitoring and oversight role. Assurance over the effective implementation of ethical standards throughout the organisation can be obtained by the board through internal audit assurance. This means that the board not only sets the ethical standard for the company but obtains assurance that the standards are being followed throughout the organisation.

The comply or explain approach required in 7.3 of the Code notes that it is necessary to report if there is an internal audit function and if there is not…" the fact and the process it employs for evaluating and continually improving the effectiveness of its risk management and internal processes." We note in the 2022 disclosure of one of the NZX Top 50 that this commentary is stated as follows:
"*the company does not have a separate internal audit function, however the Board has established procedures and policies that are designed to provide effective internal financial control…"*

The example noted above is not strictly compliant with the Code, as the disclosure has provided an explanation as to why it believes its financial controls are appropriate – not "how it evaluates and continually improves the effectiveness of its risk management and internal processes". This may be an indication of the confusion of a large organisation not fully understanding the differing roles of internal and external audit – external audit is focused on financial risk (with significant materiality constraints) and internal audit provides assurance on a risk-based approach to all organisation risks and opportunities. How all of the risks – including financial risks/opportunities and daily operations are being managed today and for the immediate future must be a key focus for governors.

Conclusion

The NZX Corporate Governance Code plays an important part in improving corporate governance in New Zealand and assisting directors in carrying out their roles and responsibilities. We support the review of the Code to help ensure its efficacy and impact on good corporate governance practices.

A successful review should result in a Code that aligns with global and local trends in good practice, drives strategic thinking and change and provides for a greater level of meaningful disclosure to owners and stakeholders. It's therefore important to get the settings right and ensure the requirements are not overly burdensome while ensuring sufficient guidance and encouragement for improvement is provided.

Self regulation has assisted the New Zealand financial sector in enabling fast and adaptive business practices. However, to remain self regulating in a globally regulated environment, New Zealand needs to ensure that it has, at a minimum, the globally recognised internal audit assurance, standards, and practices, in its critical Codes of Conduct and guidance good practice.

We appreciate the opportunity to comment on behalf of our members, and we would be happy to discuss our submission. We look forward to a proactive relationship with the NZX and are committed to strongly support your efforts to ensure good governance for publicly listed companies.

Ngā mihi nui

Jeffrey Galt

Chair of the Advocacy Committee

Steve Downes

Chief Executive