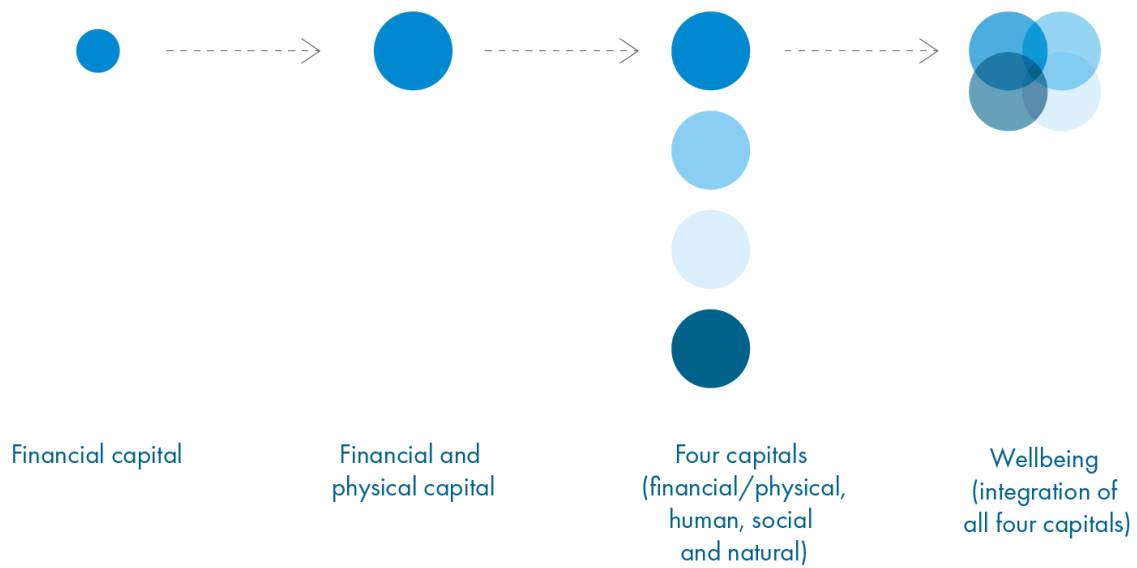


Illustrating the move from a purely financial capital focus towards an integrated wellbeing focus



About the McGuinness Institute

The McGuinness Institute was founded in 2004 as a non-partisan think tank working towards a sustainable future for New Zealand. *Project 2058* is the Institute's flagship project focusing on New Zealand's long-term future. Because of our observation that foresight drives strategy, strategy requires reporting, and reporting shapes foresight, we developed three interlinking policy projects: *ForesightNZ*, *StrategyNZ* and *ReportingNZ*. Each of these tools must align if we want New Zealand to develop durable, robust and forward-looking public policy. The policy projects frame and feed into our research projects, which address a range of significant issues facing New Zealand. The six research projects are: *CivicsNZ*, *ClimateChangeNZ*, *OneOceanNZ*, *PublicScienceNZ*, *TacklingPovertyNZ* and *TalentNZ*.

About the author

Wendy McGuinness, Chief Executive

Wendy McGuinness wrote the report *Implementation of Accrual Accounting in Government Departments* for the New Zealand Treasury in 1988. She founded McGuinness & Associates, a consultancy firm providing services to the public sector during the transition from cash to accrual accounting from 1988 to 1990. Between 1990 and 2003, she continued consulting part-time while raising children. Over that time she undertook risk management work. In 2002, she was a member of the New Zealand Institute of Chartered Accountants (NZICA) Taskforce, which published the *Report of the Taskforce on Sustainable Development Reporting*. From 2003–2004 she was Chair of the NZICA Sustainable Development Reporting Committee. In 2004 Wendy established the McGuinness Institute in order to contribute to a more integrated discussion on New Zealand's long-term future. In 2009 she became a Fellow Chartered Accountant (FCA).

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To whom it may concern,

Re: Submission to New Zealand Regulatory Board's Exposure Draft *Proposed Revision of Code of Ethics (New Zealand Institute of Chartered Accountants)*

The McGuinness Institute welcomes the opportunity to comment on the New Zealand Regulatory Board's *Proposed Revision of Code of Ethics (New Zealand Institute of Chartered Accountants)* consultation.

We have been working in the area of annual reporting for several years as part of our *Project ReportingNZ*. The key documents in this project are the draft *Report 17 – Building a Reporting Framework Fit for Purpose and Working Paper 2018/03 – Analysis of Climate Change Reporting in the Public and Private Sectors*, both of which are available on our website (www.mcguinnessinstitute.org/publications). We have primarily been focused on ensuring the reporting framework – our information infrastructure – is sufficiently durable and flexible. More specifically, this means that it needs to be both sufficiently rule-based to deliver comparable and accurate information during times of certainty and clarity, as well as being sufficiently principle-based to deliver meaningful and useful information during times of uncertainty and ambiguity.

Because we are entering a time of global uncertainty, principles, and more particularly the *Code of Ethics*, will become increasingly important as a precursor to building trust in the profession so that we can work towards a well-informed and resilient civil society. However, it is also important that the profession is able to engage, participate and have some influence over the wider regulatory framework under which it operates. The *Code of Ethics* therefore has a dual purpose: building trust in the services we provide to shareholders and stakeholders and building influence in the guidance and advice we provide to the wider public policy community.

In this submission, we highlight some issues that have risen to prominence through the course of our research, and then answer a few select questions in the consultation. Many of the issues are interrelated, which is why we have adopted this approach – firstly setting the context and then answering the questions. We consider both the New Zealand-specific context and international trends and implications.

We consider New Zealand to have a number of unique characteristics that warrant more specific detail in the proposed revised *Code* to make the *Code* 'fit for New Zealand's purpose'. We also consider the international *Codes* discussed in the proposed revised *Code* to be outdated and behind best practice – creating a policy and practice gap for members.

The primary characteristics of New Zealand that make us unique in regard to reporting are firstly the characteristics of our market as small and geographically isolated. This means our members are thin on the ground and, as a consequence, frequently interconnected. It is this combination of (i) a small number of members and (ii) those members providing a wide range of services, that results in so many conflicts of interest. We believe that there are many more conflicts of interests in New Zealand than other nation states. In addition, we believe members in New Zealand do not have a very comprehensive understanding of what a conflict of interest is and how to manage those risks. From our experience, they consider such conflicts to be negative, when, in practice, we all have conflicts of interest and it is being aware of them and making them transparent to all parties that matters. We would argue that more work needs to be undertaken to improve the dialogue on conflicts of interest in New Zealand.

Our commitment to the Treaty and our cultural diversity, natural resources, agricultural base and environmental values further set us apart. We also have some unique policy characteristics including the constitutional implications of the Treaty of Waitangi, the Green Party Member's Bill the Legislation (Climate Impact Disclosure Statement) Amendment Bill and the Zero Carbon Bill. Additionally, both our prominent

political parties have committed to transitioning to a low-carbon economy, which has wide reaching implications for accounting across all sectors.

International trends and implications of note include the pervasive uncertainty of climate change and the tensions between shareholders and stakeholders as broader issues of economic and social governance rise to prominence.

The specific points we cover are as follows:

1. Public interest;
2. Conflicts of interest (actual, perceived or potential);
3. Climate change reporting and the related issues of materiality, judgement and assurance;
4. Wellbeing budget and integrated reporting; and
5. Interests of shareholders versus stakeholders.

1. Public interest

Although the proposed revised *Code* notes that ‘member compliance with the Code of Ethics is designed to ensure that members act in the public interest and, therefore, maintain and increase trust in the profession’ (p. 7), it does not give a detailed explanation of what that means in practice. Professionals are caught between their own interests, those of their client or employer and the broader ‘public interest’. From our perspective, any Code of Ethics should be helping members negotiate these interrelated interests. Although the purpose of the Code does outline the role of the fundamental principles as ‘reflecting the profession’s recognition of its public interest responsibility’ and establishing ‘the standard of behaviour expected of a member’ (p. 6), we consider a more detailed explanation of what this means in practice to be required.

If the NZICA is committed to the public interest as ‘the collective well-being of the community and institutions the profession serves’ (p. 213), it would be useful to provide greater clarity over what that could mean in practice. For example, we would argue that climate change constitutes a significant threat to the well-being of all communities and institutions the profession may serve and therefore should be explicitly mentioned in the above definition of public interest in the glossary (see further discussion of climate change below). As another example, the concept of public interest could be illustrated by linking it to internationally recognisable measures such as the UN Sustainable Development Goals.

In my experience, the responsibility to serve the public interest was historically a much stronger and more prominent part of the accounting profession. I believe this has somewhat weakened over time. Given the current international context and imminent challenges relating to resource shortages, changes in tax regulation and compliance, and climate change, strengthening the principles of ‘integrity, objectivity, professional competence and due care, confidentiality, and professional behaviour’ (p. 6), and linking them explicitly to the public interest is of utmost importance.

2. Conflicts of interest

We consider the discussion of conflicts of interest in the proposed revised *Code* inadequate, specifically section 210: Conflicts of Interest. We have found the New Zealand Institute of Directors’ *Conflicts of Interest Practice Guide* to be a far more comprehensive guide for professionals operating in New Zealand. It is important to note that the IoD consider New Zealand is a small market, with ‘a relatively small pool of professional directors and a highly interconnected business community. This can impact the probability of conflicts of interest occurring’ (IoD, 2015).

The *Guide* draws a line between potential conflicts and action on conflicting interests, noting that ‘the existence of a conflict of interests does not necessarily mean that the director concerned has done anything wrong. What it means is that the conflict needs to be managed’ (IoD, 2015).

It also draws a clear distinction between an actual conflict, a potential conflict and a perceived conflict:

- **An actual conflict** is where circumstances are or could be perceived to influence a director’s judgement to the detriment of the company.
- **A potential conflict** occurs where it is reasonably probable that in future, an actual conflict of interests will come into play.
- In certain circumstances, there may be a **perception of a conflict of interests** where the interests come close but do not intersect. In these situations, careful management is still required. Not taking steps to manage these risks can undermine a company’s reputation and hiding conflicting interests can give rise to perceptions or allegations of misconduct. (IoD, 2015) [Bold added]

As a case study, this issue first became apparent when completing research into New Zealand King Salmon Investments Ltd (NZKS) as a result of their proposal to increase water use in the Marlborough Sounds. This became a matter of national significance. The consultation process required the preparation of a number of expert reports. The pool of experts in New Zealand is limited, making it difficult for regulators to seek truly independent experts.

Table 1 lists the 19 topics covered by the 15 research providers commissioned by MPI (but paid for by NZKS) to consult for the Marlborough Salmon Working Group (MSWG). Of the 15 consulting research providers, 11 had been expert witnesses employed by NZKS at a 2012 BOI. Furthermore, seven worked directly as part of the Boffa Miskell team for NZKS between 2009 and 2013 (Cawthron Institute, NIWA, Statfishitics, Cawthorn and Associates, Marshall Day Acoustics, Taylor Baines and OECL). This means that of the 19 research reports commissioned by MPI, 15 were authored by consultants who had benefited from a financial relationship with NZKS in the past.

Table 1: List of research commissioned for MSWG

Research	Provider
Navigation	Navigatus Consulting Ltd
Landscape and natural character	Hudson and Associates
Tourism and recreation	TRC Tourism Ltd
Seabirds	NIWA
Marine mammals	Cawthorn and Associates
Pelagic fish	Statfishitics
Benthic	NIWA and Cawthron Institute
Water quality	NIWA and Cawthron Institute
Discharges (Cu/Zn, greywater)	Cawthron Institute
Disease and pests	DigsFish and Cawthron Institute
Biosecurity	Cawthron Institute
Underwater lighting	Cawthron Institute
Noise	Marshall Day Acoustics
Cultural impact assessment	Maximize Consulting Ltd
Heritage impacts	Heritage Works
Social impacts	Taylor Baines & Associates
Economic analysis	PwC
Operations	NZKS
Engineering	OCEL

Based on our initial research, only two consultants seemed completely independent of NZKS (i.e. did not have past working relationships with NZKS).

More recently, we came across a situation where an accounting firm provided auditing services to a company in Christchurch (receiving funds for auditing services), while its Wellington branch provided services to government on an assurance report of public interest relating to the same company. The firm's existing auditing relationship was not disclosed in the assurance report. Our argument at the time was that this relationship should have been disclosed but was not. In our view, the relationship constituted a perceived conflict of interest in that a reasonable person would expect that relationship to be disclosed. However, when presenting this argument, many attendees thought we were implying an actual or potential conflict and therefore did not appreciate the public interest component of the perceived conflict. This confusion highlights the necessity of clearer definitions surrounding these issues. At the time, we turned to the existing *Code* for guidance but found it inadequate. We instead relied on other codes of ethics to explain the distinction.

The best current guidance I can find regarding perceived conflicts of interest is this set of questions posed in the *IoD Guide*:

- What would a reasonable person think?
- What would this look like as headline news?
- Would you be willing to stake the company's (and your personal) brand and reputation on the impartiality and good faith of your decision? (IOD, 2015)

In an ideal world, all consultants would be independent (in terms of actual, potential and perceived conflicts). But given the size of New Zealand, as noted above, disclosure of anything in their past history that might call their independence into question should be made transparent in the relevant reports and statements. Ideally all consultant reports should be transparent, setting out the data that has been relied upon and the processes that have been undertaken. The possibility of uncertainty over what exactly constitutes a conflict of interest is argument enough for the inclusion of NZ210.8 A1 and NZ310.14 A1 and this is further supported by discussion of independence in the *Code*. However, as noted above, the inclusion of NZ210.8 A1 and NZ310.14 A1 is not likely to be enough. For example, the concept of a perceived conflict of interest is not mentioned. More work is needed to provide clarity over the range of conflicts that may exist (i.e. providing definitions of actual, potential and perceived conflicts) and more guidance on how to manage these conflicts going forward (e.g. company/client interests versus public interests).

3. Climate change reporting and the related issues of materiality, judgement and assurance

Climate change is a clear and familiar example of the difficulties of balancing company/client interests and public interests. We believe that the issue of climate change is of sufficient urgency and magnitude to be given greater consideration and prominence in the *Code of Ethics*. Information on climate change is urgently needed to inform investors and insurers, and to shape New Zealand's public policy. In support of this argument, the Institute of Directors has outlined environmental risk as one of the organisational risks that boards should be reporting on (IoD, n.d.). Our own *Project ReportingNZ* research has highlighted the current poor quality of climate change reporting in New Zealand as well as what we consider to be an overwhelming policy gap.

As part of this, we consider definitions of materiality to be highly important. We were very interested to note the inclusion of the materiality topic in IESBA's on-going work program (p. 9). UNEP defines material issues in relation to financial accounting as something that 'has the potential to affect your perception of the company and any decisions you might take as a result', yet they acknowledge the 'nebulous' nature of the term (SustainAbility Ltd & UNEP, 2004, p. 34).

We also note that the International Accounting Standards Board (IASB) is relying on the concept of materiality as the only way for preparers to report on the risks of climate change rather than publishing a standard or guideline for climate change information. This treatment of materiality in relation to climate change risks is also evident in the recommendations of the Task Force on Climate-related Financial Disclosures (TCFD), which have garnered significant international attention. The best solution the TCFD can provide for climate change risks that cannot be deemed material (and therefore appropriate for inclusion in the notes to the financial statements) is that they be disclosed outside financial filings so that they can then be incorporated into the financial filings once they become material (TCFD, 2017). The concept of materiality is embedded in judgement and where there are high levels of uncertainty (as in the case of climate change), preparers and auditors are not required to report or assure. The fact that the concept of materiality will not necessarily catch climate change risks means that the *Code*, particularly its definition of public interest, must be strengthened. The *Code* should be designed in such a way that members who want to report or provide assurance on climate change risk can do so.

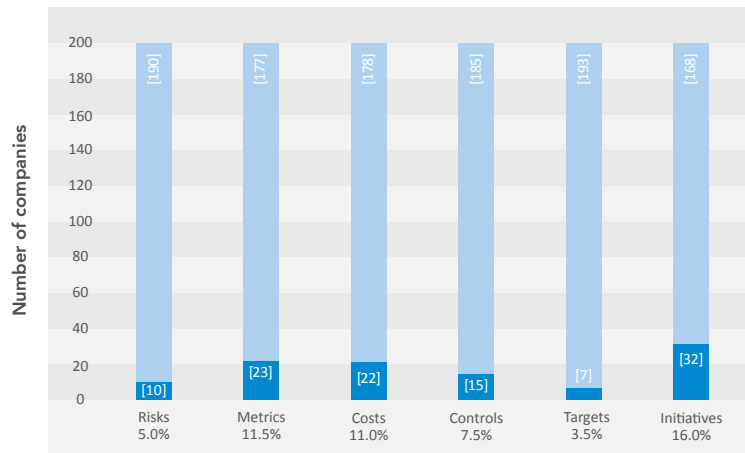
Disclosure of data on emissions and strategies to curb emissions are even more difficult to make appropriately. We consider the principle of materiality to be insufficient in relation to the uncertain risks of climate change that often have the characteristics of low-probability high-magnitude events, rather than the high-probability low-magnitude events usually covered by materiality. It is this confusion over the definition of the term that gives rise to our hope that the IESBA will take this opportunity to clarify the concept of materiality so as to result in increased disclosure of climate change risk.

This issue is also linked to the importance of judgement in the accounting profession. Judgement is centre stage in a risk-based approach, which is the most appropriate approach in times of uncertainty and for dealing with matters such as climate change. This is why it is so important that the Code of Ethics provides a sound foundation and builds capability for times when the broader regulatory framework is unable to provide clarity.

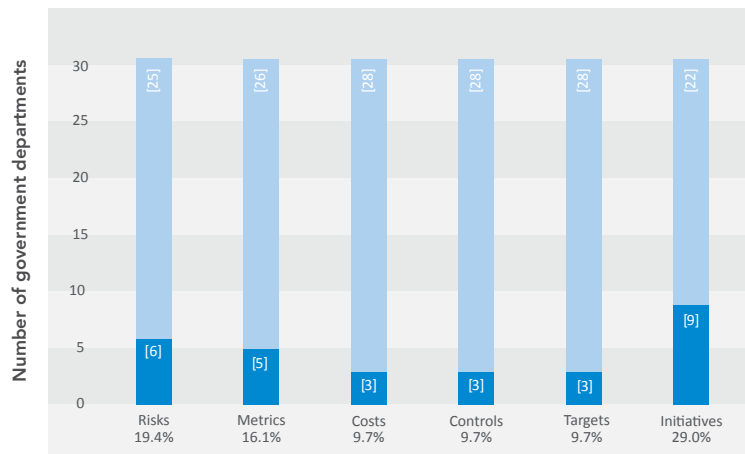
One of the recommendations arising from our work in *Project ReportingNZ* has been that a *Statement of Climate Change Information* outlining the identification, measurement and management of climate change risks be included as part of New Zealand's regulatory filings. This recommendation can be expected to carry certain implications for the accounting profession, given the fact that 'one of the most important decisions that auditors make is with regard to determining what a material misstatement is for a particular client' (Van Peurse & Pratt, 2017, p. 151).

Figure 1: Comparing climate change information disclosed in the 2017 annual reports of significant organisations

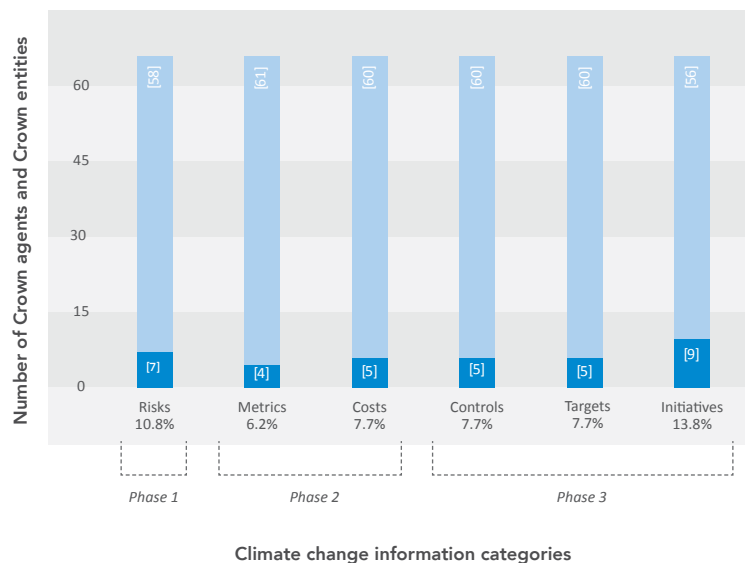
(i) 2017 Deloitte Top 200 companies [200]



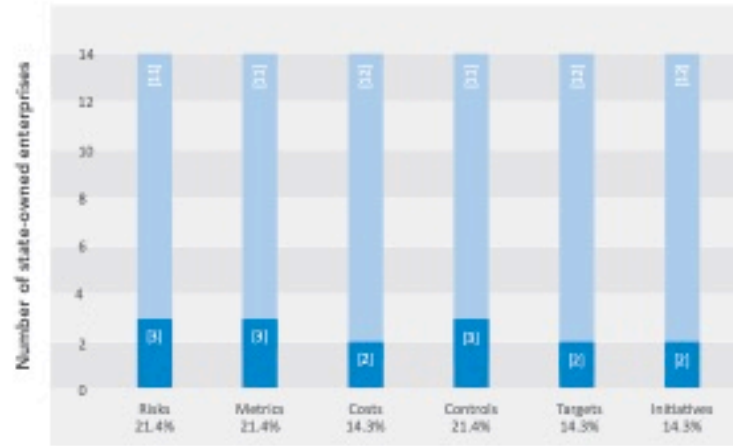
(ii) Government departments [31]



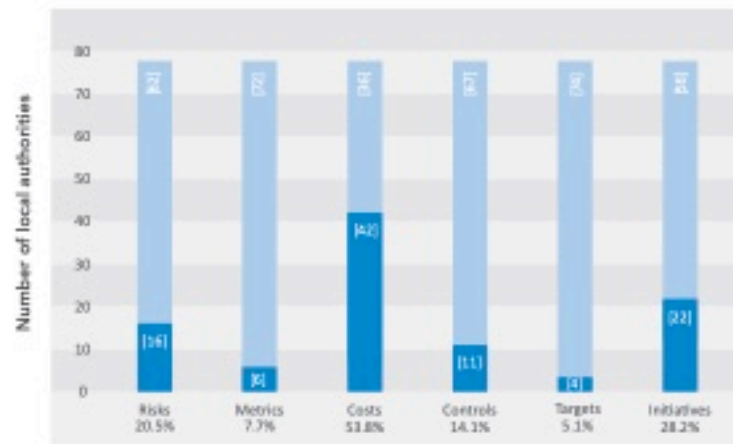
(iii) Crown agents and Crown entities [65]



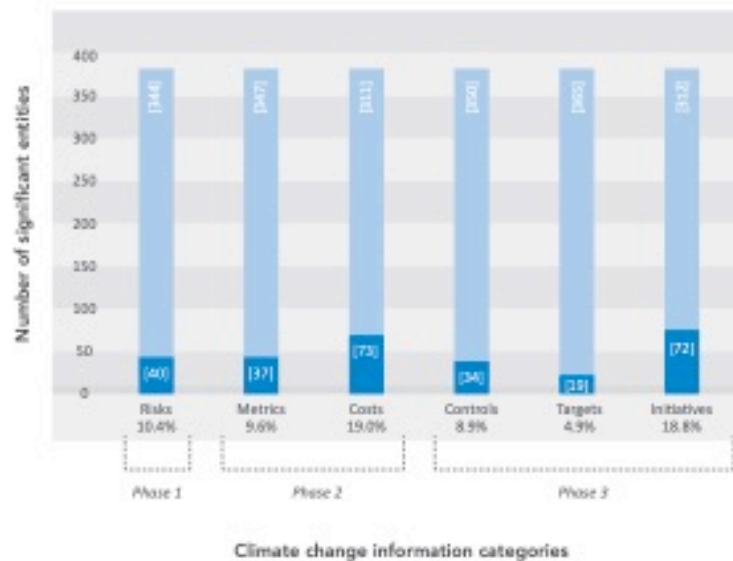
(iv) State-owned enterprises [14]



(v) Local authorities [78]



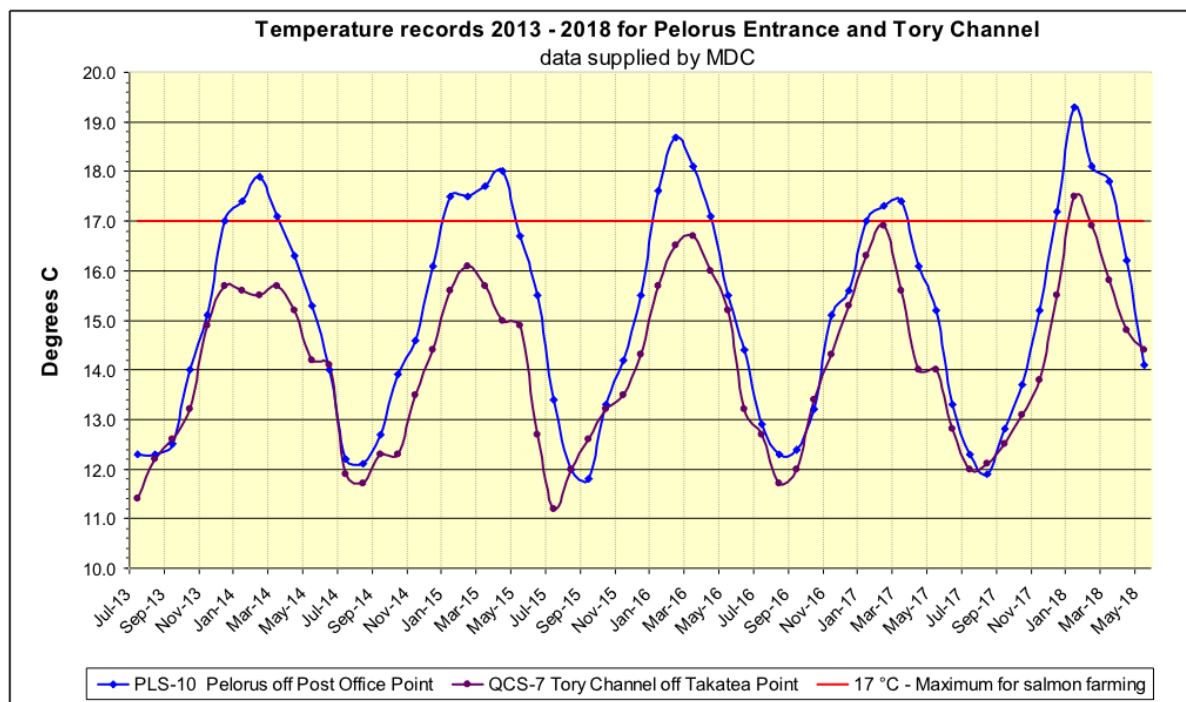
(vi) Total New Zealand entities analysed [384]



■ Did not disclose climate change information
 ■ Disclosed climate change information

Climate change will have a significant impact on the way businesses and investors operate. Figure 2 below illustrates the change in water temperatures that is leading NZKS to look for cooler water. We would argue that this risk should be better articulated in NZKS's financial statements and in NZX announcements. This is the canary in the mine; we need to find better ways to inform investors and the wider public about climate change risks.

Figure 2: Temperature records 2013–2018 for Pelorus Entrance and Tory Channel



4. Wellbeing Budget and integrated reporting

Our work on *Report 17 – Building a Reporting Framework Fit for Purpose*, particularly in ‘Section 3 – Foresight: Trends and Implications’, indicated that there is significant movement in conceptions of value and capital that will further complicate issues of judgement for the accounting profession. For example, the idea of wellbeing has taken the policy world by storm, as indicated in the Government’s Wellbeing Budget to be presented later this year and is intended to ‘broaden the Budget’s focus beyond economic and fiscal policy by using the Treasury’s Living Standards Framework to inform the Government’s investment priorities and funding decisions’ (Treasury & NZ Government, 2018). Treasury’s Living Standards Framework is itself an explicit acknowledgement of the importance of factors outside of financial capital for delivering value and measuring success, namely human, social and natural capitals.

The diagram that forms the cover of this submission provides an illustration of this point.

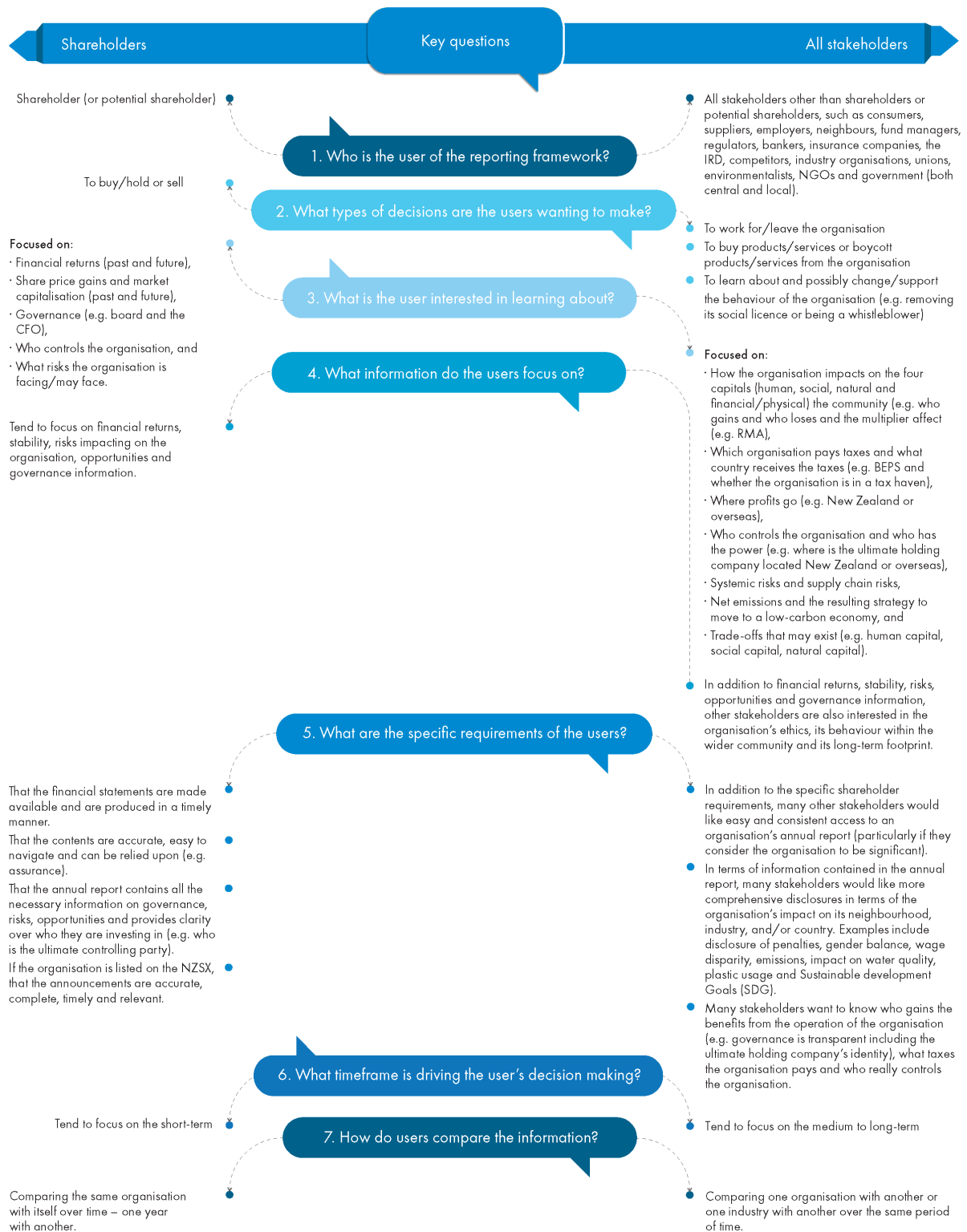
We believe these are new dimensions of accounting that will create more uncertainty. This trend is also linked to the increase in shareholder activism and the blurring of shareholder interests and stakeholder interests as shareholders become more interested in social and environmental value (see point 5 below). In turn, this is likely to result in higher levels of integrated reporting and use of other frameworks and guidelines that recognise the importance of non-financial information. The increasing necessity for reporters to provide non-

financial information supports the argument that as judgement becomes more central in accounting, reporting and assurance processes, the *Code of Ethics* becomes more important for guiding those judgements.

5. Interests of shareholders versus stakeholders

As another matter of public interest, we note the increasing tension in New Zealand's reporting framework between the interests of shareholders and stakeholders. This insight again was gained from *Report 17 – Building a Reporting Framework Fit for Purpose* and is outlined in 'Section 6.1: Policy Knots Shaping the Reporting Framework', which found many areas in which it was unclear who the framework was intended to serve. These tensions are also illustrated in Figure 3 below.

Figure 3: Comparing shareholders and stakeholders as key users of the reporting framework



This debate is also outlined in a recent Financial Times article by Andrew Edgecliffe titled *Beyond the bottom line: should business put purpose before profit?*:

A decade after the financial crisis shook voters' confidence in capitalism, the challenges to Friedman's model have been gathering momentum. Now — even as US President Donald Trump pursues stereotypically “pro-business” policies such as cutting corporate taxes and regulations — they are starting to converge into something that looks like a new worldview, shared by leading executives and investors and shaped by an unlikely alliance of consumers, employees, campaigners, academics and regulators. Together, they could break a consensus that has governed business for two generations and offer a new model for capitalism based on the watchwords of purpose, inclusion and sustainability.

For this capitalist reformation to succeed, however, it will have to prove it has more substance than spin, survive the market's down cycles and persuade a public whose faith in corporate and institutional elites remains fragile.

Most of the capitalists an FT journalist meets in 2019 sound more like the protesting shirtmakers of the 1970s than the Nobel-winning economist. Over the past year I have had business leaders lament to me that no Wall Street analyst ever asks them about their efforts to tackle climate change; I have seen companies such as Merck and Johnson & Johnson remind investors that their pre-Friedman founders believed profits would only flow if they attended to other priorities first; and I have heard Unilever's outgoing CEO Paul Polman ask provocatively: “Why should the citizens of this world keep companies around whose sole purpose is the enrichment of a few people?”

Strikingly, their arguments have been echoed by the world's biggest investors, the very people who seem most at risk in any shift from shareholders' interests.

...

With governments failing to prepare for the future, [BlackRock's Larry Fink] wrote, people were looking to companies to deliver not only financial performance, but a positive contribution to society, benefiting customers and communities as well as shareholders. Without a social purpose, he contended, companies fail to make the investments in employees, innovation and capital expenditures needed for long-term growth — and above-par returns to the likes of BlackRock.

A further article illustrates the blurring of these boundaries between shareholders typically considered to be driven by increasing profit and stakeholders typically considered more likely to be concerned about the environment. Coal company Glencore recently made a statement of carbon intent agreeing to limit their coal production to current levels. The concession statement says ‘to deliver a strong investment case to our shareholders, we must invest in assets that will be resilient to regulatory, physical and operational risks related to climate change’ (Stevens, 2019).

Responses to Questions for Members

4. Do you agree with the amendments to the NZ specific provisions? Please explain any issues you have identified.

We agree with the amendments to the NZ specific provisions. On principle, we believe that New Zealand is sufficiently unique to warrant specific provisions and support their inclusion.

6. Do you agree with the inclusion of NZ210.8 A1 and NZ310.14 A1 (conflicts of interest)? Should the guidance be elevated to a requirement? Please explain your response.

The McGuinness Institute firmly believes in the importance of being transparent over conflicts of interest, whether these are actual, potential or perceived. In regard to this matter, transparency and high levels of disclosure are advisable. For this reason, we believe it would be beneficial for the integrity of the accounting profession in New Zealand if the guidance in NZ210.8 A1 and NZ310.14 A1 was elevated to a requirement.

9. Are there any additional issues that need to be addressed for the New Zealand context? Please provide details.

We note that the only mention of environmental issues is made in Section 260 in relation to compliance with laws and regulations.

10. Are you aware of any regulatory or other issues in the New Zealand environment that may affect the implementation of the proposed amendments? Please provide details.

We are not aware of any regulatory or other issues that may affect the implementation of the proposed amendments. We also note that the term environment used in the question here might be better referred to as landscape.

11. Are there any issues arising from the proposed Code that you consider should be raised with IESBA when the International Code is next updated? Please provide details.

As mentioned, the Institute considers the matter of climate change to be of utmost importance. It is our hope that any future updates of the International Code would take the Paris Agreement and other international commitments to climate action into account. The accounting profession should remain aligned with these and should be seen to be leading the way in environmental ethics as well as professional ethics.

This will be particularly relevant in light of the rate of change associated with the necessary and overdue transition to a zero-carbon economy, both in New Zealand and globally. This is likely to necessitate another review of the *Code of Ethics* in the near future in order to ensure that it remains appropriate and supportive of the accounting profession's mandate to serve the public interest.

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