Document 3: Supporting Evidence

Submission to NZX on::
(i) Exposure Draft: NZX Corporate Governance Code Review – Second Consultation
(ii) Exposure Draft: NZX ESG Guidance Note – Initial Consultation

18 October 2022 (FINAL)

1.0 Introduction

The Institute welcomes the opportunity to offer feedback on the *Exposure Draft of the Corporate Governance Code* (the *Draft Code*), the 3 August 2022 *NZX Corporate Governance Code Review* (the *Code Review*), the *Exposure Draft: ESG Guidance Note* (the *Draft ESG Guide*) and the 3 August 2022 *ESG Guidance Note Consultation Paper* (the *ESG Consultation*). Please note when we refer to the resulting document, we either include the word final in front (e.g. the final *Code*) or the full formal name (e.g. *Corporate Governance Code*).

This submission covers both the *Corporate Governance Code* and the *ESG Guidance Note.*

Our submission includes three separate documents.

1. **Document 1: Summary and Q&A:**
   This document is the overarching document. It aims to provide a summary of the other two documents (mentioned below) and answer specific questions raised by NZX. Section 2.0 identifies some trends and emerging issues. Specific questions raised in the consultation are answered in Sections 3.0 (i.e. the *Code Review*, 7 questions) and 4.0 respectively (*ESG Consultation*, 4 questions).

2. **Document 2: Draft ESG Guide McGuinness tracked version:**
   The second document contains our suggested changes to the August 2022 *Draft ESG Guide.* Suggested changes to the *Draft Code* are discussed in this document but given the extent of the changes we are proposing, we thought a *Draft ESG Guide McGuinness tracked version* would enable NZX staff to easily understand what these changes might look and feel like in the final *ESG Guidance Note.*

3. **Document 3: Supporting evidence (this document):**
   The third document contains recent research by the McGuinness Institute,[1] as well as a list of recent developments, events and ideas that have come to our attention as a result of our continued scanning of the global reporting landscape. At one level it can be thought of as a journey through our observations and thoughts – what we have found interesting and of note. At another level it enables the Institute to have a record that in effect updates our 2020 *Report 17 – ReportingNZ: Building a Reporting Framework Fit for Purpose.* Below we discuss McGuinness Institute research in Section 2 and other relevant events and research in Section 3. The aim is to identify and provide supporting evidence to the recommendations and discussion in the earlier two documents.

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

The Institute would like to thank the NZX management for actively seeking out better ideas and processes for improving and showcasing New Zealand's stock exchange on the international stage. By doing so, investors seeking trusted and sustainable investments are more likely to seek out companies listed on NZSX.

2.0 McGuinness Institute Research

2.1 Working Paper 2022/15 – Reviewing Voluntary Reporting Frameworks Mentioned in 2018–2021 Annual Reports from NZSX-listed companies[1]

This working paper provides a quantitative assessment of the state of environmental reporting in New Zealand by recording which voluntary frameworks entities mentioned in their 2021 annual reports. We have performed the same research on 2017, 2018, 2019 and 2020 annual reports. This document provides evidence for aspects of the *Summary and Q&A* and the *Draft ESG Guide McGuinness Institute tracked version*.

Finding 1: The three commonly mentioned or applied frameworks/instruments among analysed 2021 annual reports were the TCFD (Task Force on Climate-related Financial Disclosures) [43], UN SDGs (United Nations Sustainable Development Goals) [24], and the GRI (Global Reporting Initiative) [22].

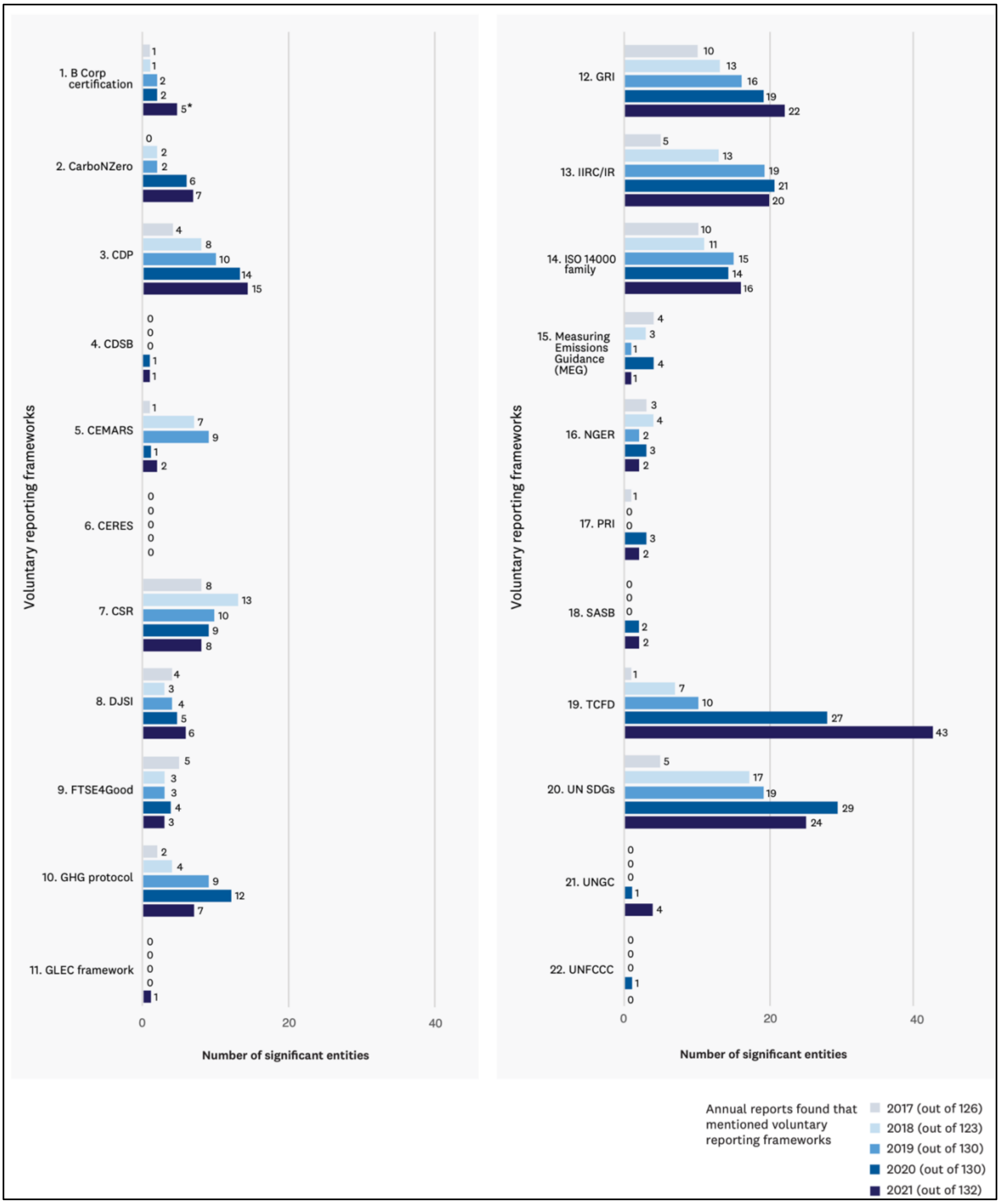
Finding 2: 10 frameworks had increased mentions: B Corp certification, CarboNZero, CDP, CEMARS, DJSI, GLEC framework, GRI, ISO14000 family, TCFD and UNGC.

Finding 3: A number of NZSX-listed companies mentioned more than one framework within their annual reports, with Fisher & Paykel Healthcare Limited mentioning nine.

Refer to Figure 1 overleaf for a comprehensive graph of results.

Figure 1: Mentions of 22 voluntary reporting frameworks in the annual reports of NZSX-listed companies from 2017 to 2021

Source: McGuinness Institute, Figure 1, *Working Paper 2022/15 – Reviewing Voluntary Reporting Frameworks Mentioned in 2018–2021 Annual Reports from NZSX-listed companies*[2]



* Note: Greenfern Industries Limited (another NZSX-listed company that is a B Corp Certified company[3]) has been excluded from the 2021 B Corp total of five as presented in Figure 1 because it did not publish a 2021 annual report.

2.2 Working Paper 2022/14: Reviewing TCFD information in 2017–2021 annual reports of NZSX-listed companies[4]

Task Force on Climate-related Financial Disclosures (TCFD) is the framework upon which the External Reporting Board's (XRB) climate standards are being shaped by. This working paper provides a quantitative assessment of the state of climate reporting through the lens of NZSX-listed companies that have published annual reports mentioning the TCFD between 2018 and 2021. This quantitative research is intended to show how the TCFD framework is being voluntarily applied by different NZSX-listed companies. Importantly, to meet the Institute's definition of a complete TCFD report, the report must contain all four core elements as outlined in the *Recommendations of the Task Force on Climate-related Financial Disclosures* (2017).

Finding 1: Climate reporting is gathering support. In 2021 annual reports TCFD was mentioned over six times more than in 2018.

Table 1: Percentage of companies whose annual reports mention TCFD
Source: McGuinness Institute, Table 3, *Working Paper 2022/14: Reviewing TCFD information in 2017–2021 annual reports of NZSX-listed companies*[5]

Year	NZSX-listed companies whose annual reports were searched for mentions of TCFD	Total number of annual reports that mentioned TCFD	Percentage of companies' annual reports
2017	126	1	0.8%
2018	123	7	5.7%
2019	130	10	7.7%
2020	130	27	20.8%
2021	132	43	32.6%

Finding 2: In 2021 annual reports TCFD was reported on over nine times more than in 2018.

Table 2: Percentage of companies whose reports contain all four core TCFD elements
Source: McGuinness Institute, Table 3, *Working Paper 2022/14: Reviewing TCFD information in 2017–2021 annual reports of NZSX-listed companies*[6]

Year	NZSX-listed companies whose published reports were reviewed for TCFD information	Number of companies who published reports that contained all four core elements of a TCFD report	Percentage of companies reporting on all four core TCFD elements
2017	126	0	0%
2018	123	2	1.6%
2019	130	6	4.6%
2020	130	14	10.8%
2021	132	19	14.4%

Finding 3: Over half of TCFD reporters of 2021 annual reports did not take into account all six types of extreme weather and climate events addressed in Chapter 11 of the Intergovernmental Panel on Climate Change's (IPCC's) *Climate Change 2021: The Physical Science Basis.*

Finding 4: Almost a third of TCFD preparers of 2021 annual reports did not take into account compounded events (defined by the IPCC as 'the combination of multiple drivers and/or hazards that contributes to societal and/or environmental risk').[7]

Finding 5: Almost half of TCFD reporters of 2021 annual reports did not to take into account drought events.

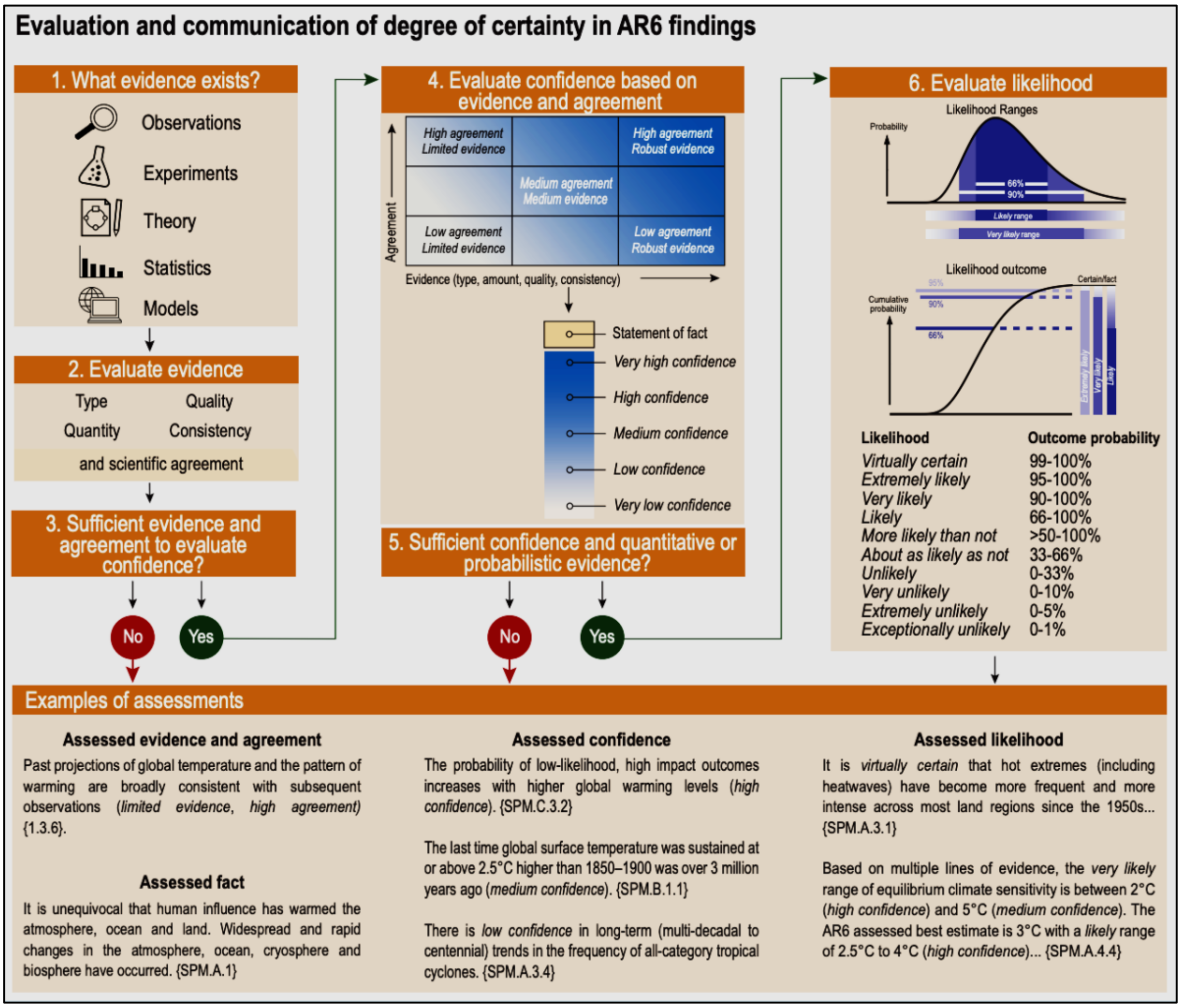
Finding 6: While using IPCC data to analyse TCFD reporters of 2021 annual reports, we found that medium confidence, low confidence and very low confidence data is not taken into account in Chapter 11 of the IPCC's report, when establishing likelihood of an extreme event (see explanation below). Given that issuers preparing climate statements will need to seek out and understand the latest science, we explore below how the IPCC deal with data that is uncertain.

Exploring IPCC's approach to data that is uncertain

Chapter 1 of the IPCC report sets out the contents, framing and methods that the report then applies to the currently available data and evidence throughout the report. Figure 2 below is a flowchart of the process used. Steps 4–6 analyse confidence in the data, then assess the likelihood of climate events only if there is high or very high confidence in the data. If the confidence in the data is either very low, low, or medium, it will not be used to predict the likelihood of events.

Figure 2: The IPCC AR6 approach for characterising understanding and uncertainty in assessment findings

Source: IPCC, Chapter 1, Figure 1, *Climate Change 2021: The Physical Science Basis*.[8]



The TCFD reports of the 19 companies that achieved full reporting on all four core elements were further analysed in order to see how they understood climate-related risks. The reports were searched for mentions of the six types of weather and climate extremes outlined in Chapter 11 of the IPCC's *Climate Change 2021: The Physical Science Basis*. Figures 4–5 show the results.

The purpose of Working Paper 2022/14: Reviewing TCFD information in 2017–2021 annual reports of NZSX-listed companies

The Institute was trying to understand whether TCFD reporters were taking into account all six types of extreme weather and climate events, and whether they were giving these equal weight.

What we found

Reporters rarely look at compound events (combinations of extreme events). We believe that compound events, although relatively poorly understood due to their complexity, need to be more frequently considered and discussed. A recent example of compounded events is Pakistan, where almost 30 percent of the country was under water in mid-2022. This was due not only to the scale of the monsoon rains, but a change in the location of those rains – preventing water from draining out to sea and instead pooling in the country's agricultural basin.[9] See Figures 3–5.

These findings raise several questions regarding the reporting of both financial and non-financial risk that are worth considering:

(i) How should reporting for uncertainty and extreme climate events be accounted for? What measures, or lack thereof, currently exist to ensure that the reporting of less understood and documented events ('what we know we don't know' or 'what we don't know we don't know') is not completely neglected in place of the better understood mainstream ('what we know we know').

(ii) What happens when accountants are faced with data that scientists have little confidence in (as a result of issues such as a lack of data quality or quantity – the input), and how might this influence likelihood/probability and magnitude/impact information (the output)? For example, how might this impact on the reporting of risk?

(iii) How do we ensure/prepare/provide guidance to climate reporters so that they are firstly aware of new combinations of climate events (compound events as in the example of the flooding in Pakistan), and secondly, reporting against these new combinations? An easy way to answer this may be scenarios but perhaps more is needed.

Figure 5 illustrates the variance of reporting across industry on the six difference extreme weather and climate events. The figure aims to illustrate that reporting gaps exist across industry when considering extreme weather and climate events. Though sample sizes were small and varied between industry, it was found that Division A (sample size of 1) reported best against all six different extreme weather and climate events, followed by Division I (sample size of 4), and then Division D (sample size of 6).

Figures 6 and 7 have been adapted from information presented in Chapter 11 of the IPCC's *Climate Change 2021: The Physical Science Basis*. Figure 6: *Confidence in the quality of data concerned with the occurrence of extreme climate events* illustrates that not all data is created equal. It shows that those preparing risk data should firstly analyse and explain the level of confidence they have in the data. Figure 7: *Likelihood of an extreme climate event occurring where there is high confidence or very high confidence in the quality of data* illustrates that preparers need to consider not only what to do with the data they have high or very high level of confidence in, but also what they do not have confidence in (i.e., have medium, low or very low confidence in).

Figure 3: New types of unprecedented extremes that will occur as a result of climate change
Source: IPCC, *Climate Change 2021: The Physical Science Basis*.[10]

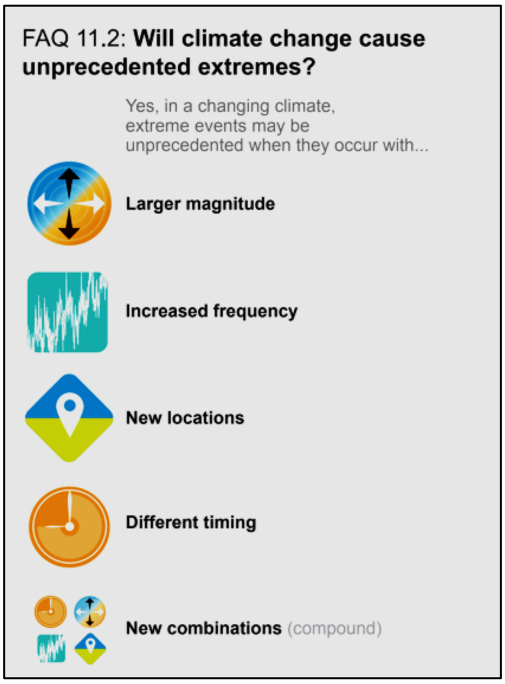


Figure 4: Types of IPCC weather and climate extremes mentioned in TCFD reporting of 19 NZSX-listed companies, 2021
Source: McGuinness Institute, Figure 4, *Working Paper 2021/14: Reviewing TCFD information in 2017–2021 annual reports of NZSX-listed companies*[11]

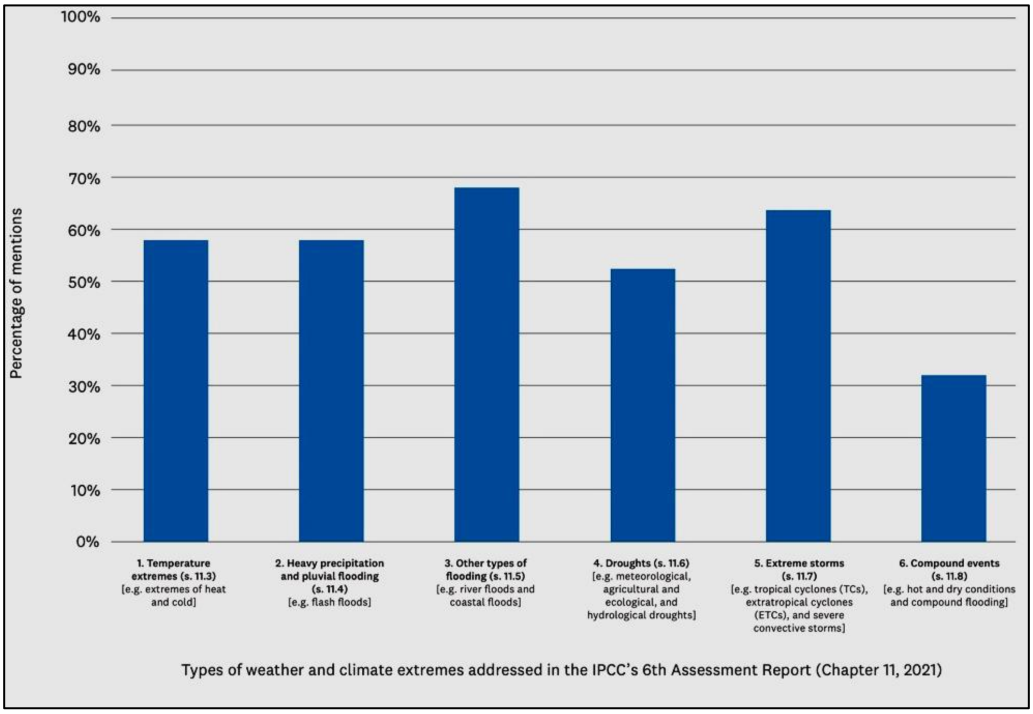
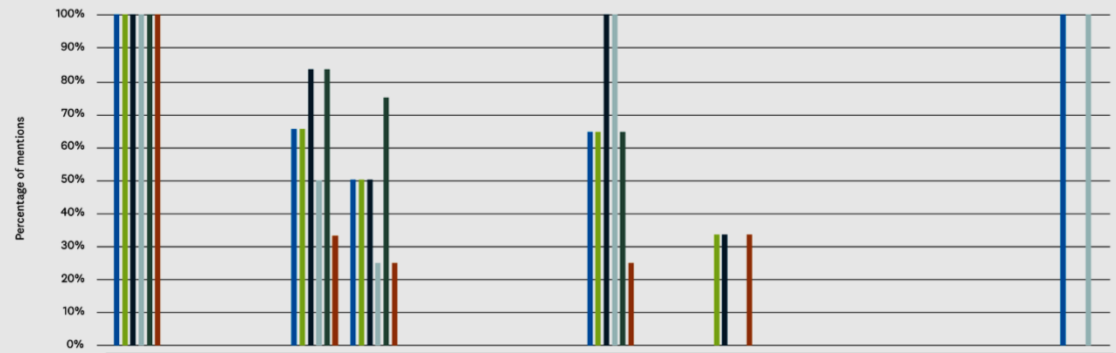


Figure 5: Types of IPCC weather and climate extremes mentioned in TCFD reporting of 19 NZSX-listed companies by industry type (ANZSIC 2006 divisions), 2021

Source: McGuinness Institute, Figure 5, *Working Paper 2021/14: Reviewing TCFD information in 2017–2021 annual reports of NZSX-listed companies*[12]



	Division A: Agriculture, forestry and sishing (sample of 1)	Division B: Mining	Division C: Manufac-turing	Division D: Electricity, gas, water and waste services (sample of 6)	Division E: Construc-tion (sample of 4)	Division F: Wholesale trade	Division G: Retail trade	Division H: Accomo-dation and food services	Division I: Transport, postal and warehous-ing (sample of 4)	Division J: Information media and telecom-munica-tions	Division K: Financial and insurance services (sample of 3)	Division L: Rental, hiring and real estate services	Division M: Profes-sional, scientific and technical services	Division N: Adminis-trative and support services	Division O: Public adminis-tration and safety	Division P: Education and training	Division Q: Healthcare and social assistance (sample of 1)
1. Temperature extremes (s. 11.3) [e.g. extremes of heat and cold]	100%	0%	0%	67%	50%	0%	0%	0%	75%	0%	0%	0%	0%	0%	0%	0%	100%
2. Heavy precipitation and pluvial flooding (s. 11.4) [e.g. flash floods]	100%	0%	0%	67%	50%	0%	0%	0%	75%	0%	33%	0%	0%	0%	0%	0%	0%
3. Other types of flooding (s. 11.5) [e.g. river floods and coastal floods]	100%	0%	0%	83%	50%	0%	0%	0%	100%	0%	33%	0%	0%	0%	0%	0%	0%
4. Droughts (s. 11.6) [e.g. meteoro-logical, agricultural and ecological, and hydrological droughts]	100%	0%	0%	50%	25%	0%	0%	0%	100%	0%	0%	0%	0%	0%	0%	0%	100%
5. Extreme storms (s. 11.7) [e.g. tropical cyclones (TCs), extratropical cyclones (ETCs), and severe convective storms]	100%	0%	0%	83%	75%	0%	0%	0%	75%	0%	0%	0%	0%	0%	0%	0%	0%
6. Compound events (s. 11.8) [e.g. hot and dry conditions and compound flooding]	100%	0%	0%	83%	25%	0%	0%	0%	25%	0%	33%	0%	0%	0%	0%	0%	0%

Figure 6: Confidence in the quality of data concerned with the occurrence of extreme climate events

Source: McGuinness Institute, Figure 2, *Working Paper 2021/14: Reviewing TCFD information in 2017–2021 annual reports of NZSX-listed companies*[13]

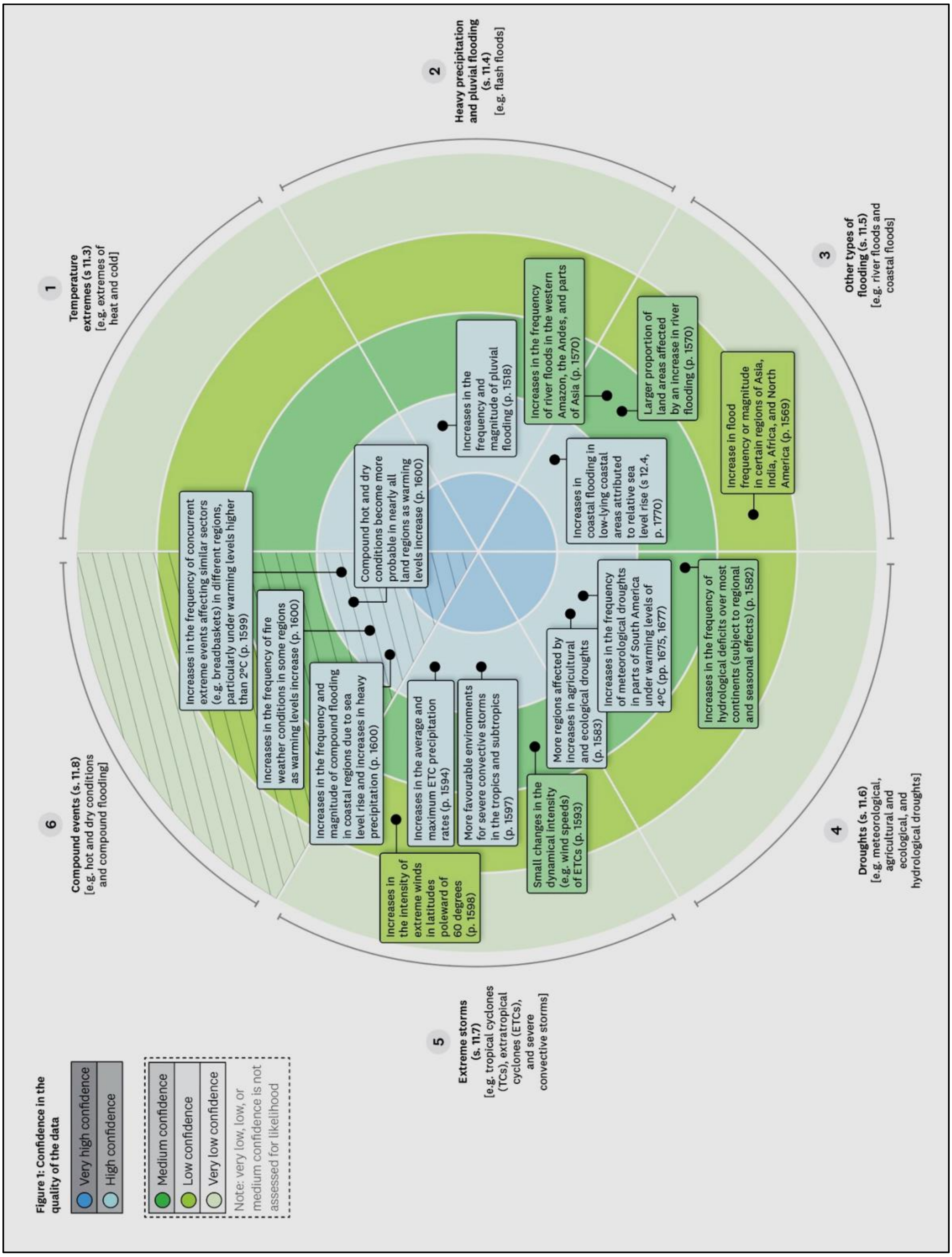
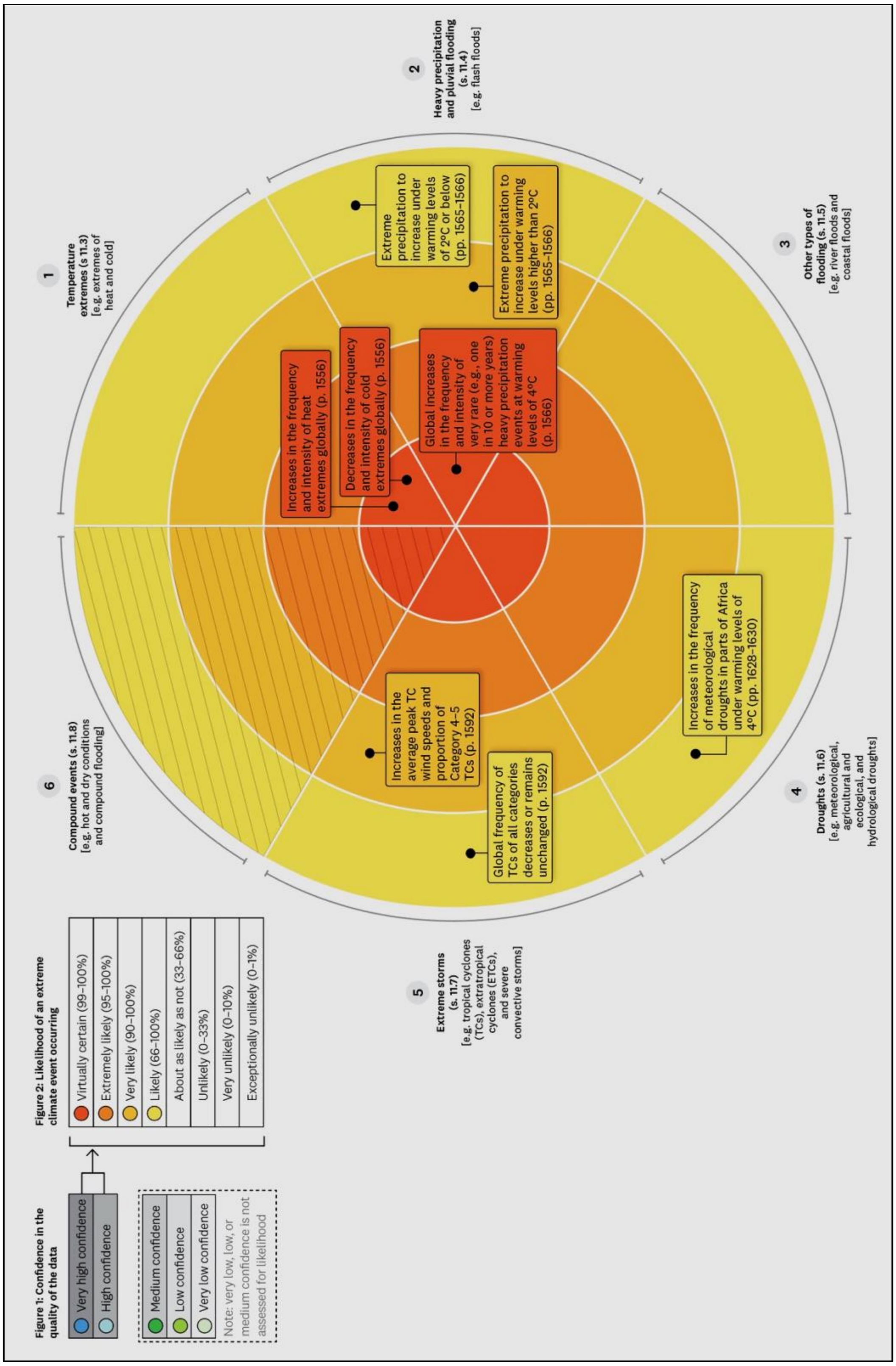


Figure 7: Likelihood of an extreme climate event occurring where there is high confidence or very high confidence in the quality of data

Source: McGuinness Institute, Figure 3, *Working Paper 2021/14: Reviewing TCFD information in 2017–2021 annual reports of NZSX-listed companies*[14]



2.3 Legal Opinion: 2020/01 – Obligations on directors to report risk in New Zealand annual reports under the Companies Act 1993[15]

Finding 1: The Companies Act 1993 does not require the reporting of either general risk or financial risk due to events such as pandemics or climate change. Neither ss 208 or 211 specifically require the reporting of such risks. An opportunity exists to include a requirement of the reporting of such risk within the Companies Act 1993 and NZX *Listing Rules* and guidance.

In May 2020 the Institute contacted Fitzgerald Strategic Legal to explore the existing framework for annual reporting and the extent to which, under the Companies Act 1993, companies and directors are required to disclose risk, including climate and pandemic risk.

Sections 208 and 211 of the Companies Act 1993 consider general reporting obligations separately to the financial reporting obligations set out in the preceding sections.

Within s 208, titled 'Obligation to prepare an annual report', lies subsection 2, which requires the board of every company to which this section applies to prepare an annual report 'on the affairs of the company during the reporting period'. Section 208 is very general. Even though it is subject to s 211, the board is left to decide the extent to which the 'affairs' of the company are disclosed. The term 'affairs' is also capable of a broader meaning.

In contrast to s 208, s 211 is more specific and prescriptive, stating the particular content and requirements that an annual report needs to meet, including changes in the 'nature of the business of the company'. S 211 however does not require an annual report to disclose either perceived or imminent risk.

Sections 196–207ZB of the Companies Act 1993 set out the manner of financial reporting and generally require financial statements to be prepared in accordance with the applicable financial standards that are appropriate to the size and nature of the company and the concerns of its shareholders. None of these financial reporting sections are concerned with a requirement to report general risk or financial risk. These are instead dealt with by the various reporting standards.

Finding 2: The existing reporting standards provide preparers with little direction in terms of a general disclosure of risks.

The legal opinion noted that a general reporting requirement is present in paragraph 125 of *New Zealand International Accounting Standard 1* (NZ IAS 1, see Figure 8 below); the scope was observed as relatively narrow, particularly in the phrases 'carrying values of assets and liabilities' and 'the next financial year'.

Figure 8: Paragraph 125 of NZ IAS 1: Presentation of Financial Statements
Source: External Reporting Board (XRB)

125 An entity shall disclose information about the assumptions it makes about the future, and other major sources of estimation uncertainty at the end of the reporting period, that have a significant risk of resulting in a material adjustment to the carrying amounts of assets and liabilities within the next financial year. In respect of those assets and liabilities, the notes shall include details of:

(a) their nature, and

(b) their carrying amount as at the end of the reporting period.

While specific requirements in respect of the risk of certain financial instruments were acknowledged, it was unclear if any of the existing standards required a more general disclosure of the types of risk mentioned above.

With the above findings in mind, an opportunity exists for financial reporting standards to require the reporting of such risk. As such, this reporting would become mandatory under the Financial Reporting

Act 2013 and subsequently the Companies Act 1993, and for the companies to which the standards applied.

2.4 Discussion Paper 2022/02 – New Zealand King Salmon Case Study: A financial reporting perspective[16]

This is a detailed review of one particular company. It forms part of the Institute's *Project OneOceanNZ* and *Project ReportingNZ*. The overarching aim of this discussion paper is to understand whether the existing regulatory process is ready to manage the challenges of climate change, and more specially climate-related financial disclosures, by using New Zealand King Salmon (NZKS) and its FY22 annual report, along with other relevant documents, as a case study. This paper raises and then attempts to answer a number of questions.

(i) Concerns about the use of pro forma reporting

Finding 1: Pro forma results in announcements made by NZKS on the NZX may have misled shareholders, giving them a false sense of confidence. We consider NZX should stipulate in *Listing Rules* that 'Result Announcements' must not include Pro forma data.

The board and the management made the following announcements on the NZX Main Board:

1. On 31 March 2022, NZX published a 'New Zealand King Salmon – Results Announcement Date Waiver' (8:30am, 31 March 2022),[17] stating: 'Although we are still finalising our financial results, we continue to expect our FY2022 pro forma EBITDA to be in the previously indicated range of $6.5m – $7.5m.'[18] This announcement had little impact on the share price (see point 2, Figure 10).

2. However, by 8 April 2022 (8 days after the 31 March 2022 announcement), the share price began to drop (see point 3, on Figure 10). By 14 April the market had responded (possibly as word of the scale of mortalities spread in the community, post-31 January 2022, see Figure 11).

3. On 13 April 2022 (13 days after the 31 March 2022 announcement and five days after the share price dropped), shareholders were advised: 'New Zealand King Salmon Investments Limited has requested a trading halt pending a material announcement regarding its full year results and a potential capital raising.'[19]

4. Later that day (1:39 pm), the results and equity raising were made public.[20] The final 2022 annual report GAAP results (results prepared in line with generally accepted accounting principles) were materially different from the pro forma results issued only 13 days earlier: GAAP EBITDA (earnings before interest, taxes, depreciation, and amortisation) was -$15.593m (whereas pro forma EBITDA was a profit of $6.698m) and GAAP NLAT (net loss after tax) was -$73.202m (whereas pro forma NLAT was a loss of -$55.715m); see reconciliation on p. 9 of NZKS's 2022 annual report.

5. In contrast to the 31 March 2022 announcement, this announcement did make a significant impact on the share price (see Figure 10). NZKS launched a $60m rights offer to existing shareholders (closing 6 May 2022).

When comparing the FY2022 results with those of FY2020 (the last 12-month year), the changes are as follows:

In terms of cash:

- Freight costs increased by $9.924m (FY2022: $25.275m; FY2020: $15.351m)
- Financial costs increased by $0.888m (FY2022: $2.636m; FY2020: $1.748m)

In terms of non-cash transactions and valuations:

- Impairment of goodwill: (FY2022: $39.255m; FY2020: $0) (see Figure 9, FY2022 Note 5: Impairment).
- Impairment (other than goodwill): (FY2022: $20.0m; FY2020: $0) (see Figure 9, FY2022 Note 5: Impairment).
- Depreciation for property, plant and equipment – a difference of $0.74m (FY2022: $10.125m; FY2020: $9.385m) (see FY2022, Notes 16, 17 and 18).
- Fair value gain on biological transformation – a difference of $22.863m (FY2022: $41.261m [12-months to 31 January]; FY2020: $64.124m [12-months to 30 June])25 (see FY2022, Note 15).

Taking into account the transactions above, the 2022 NLAT (2022: -$73.202m) would have been more like a NPAT of $19.581m (which is similar to the years 2017–2020, see Table 3 and Figure 12). In the Institute's view, the freight costs were one of the reasons for the loss in FY2022.

The Institute's view is that the pro forma results announced on 31 March 2022 may have given shareholders a false sense of confidence; however, this changed as early as 8 April 2022. See Figure 10 below.

Table 3: NPAT/-NLAT 2015–2022 (for financial years of a 12-month period)
Source: McGuinness Institute, Table 3, *Discussion Paper 2022/02 – New Zealand King Salmon Case Study: A financial reporting perspective*[21]

Year (12-months)	Millions ($000,000)
2022	-$73.202
2020	$18.004
2019	$11.350
2018	$16.125
2017	$22.764
2016	$2.593
2015	$6.259

Finding 2: We consider NZX should stipulate in *Listing Rules* when issuers are required to report an event has begun (that may prove to be significant) verses when an actual significant event has occurred or still occurring (but has already had a significant impact).

Figure 11 illustrates that significant deaths began in Dec and occurred over a four month period (Dec, Jan, Feb and March). NZKS reported a mortality event was occurring on 1 February 2022 (see Figure 14). We consider that was late given the size of mortalities in Dec and early Jan. For example, we suggest on 1 January 2022 NZKS should have reported a mortality event was 'occurring' and on 1 February 2022 NZKS should have reported 'the size and impact' of the event at that time. We consider NZX should set out in the *Listing Rules,* the threshold for when an event should be reported because it is beginning to occur (and may have a significant impact) verses when an occurring event should be reported because it has already had a significant impact.

Figure 9: NZKS 2022 financial statements, Note 5: Impairment
Source: McGuinness Institute, Figure 4, *Discussion Paper 2022/02 – New Zealand King Salmon Case Study: A financial reporting perspective*[22]

5. IMPAIRMENT

	2022 12 Months $000	2021 7 Months $000
Plant, equipment and fittings	12,116	-
Vehicles and sea vessels	511	-
Development in progress	5,587	-
Trademarks	13	-
Farm and hatchery licenses	1,009	-
Software	763	-
Goodwill	39,255	-
Total impairment	**59,255**	**-**

As noted in Note 17 Intangible assets. Following on from an unexpected increase in sea farm mortality predominantly seen at our warmer sites towards the end of FY22, the Group has approved a strategy change to reduce farming at our warmer sites over summer. This strategy has a significant impact on future harvest volumes and therefore a reduction in future cash flows. A value in use calculation using a discounted cash flow approach (DCF) was prepared to estimate the recoverable amount of the CGU, with a resulting valuation single point of $183m. The DCF resulted in $39.255m impairment to goodwill and additional impairment of $14.4m which has been allocated on a pro rata basis to intangible assets and plant and equipment. Consideration has been given as to the status of development projects in light of the current financial environment and the impact this has on the capacity to complete significant capital projects. As a result, the capitalised development costs have been impaired at balance date.

Figure 10: NZX: NZKS price history [NZK]
Source: McGuinness Institute, Figure 53, *Discussion Paper 2022/02 – New Zealand King Salmon Case Study: A financial reporting perspective*[23]

1. NZK Market Update (12:41 pm, 1 February 2022)[199]
2. New Zealand King Salmon – Results Announcement Date Waiver (8:30am, 31 March 2022)[200]
3. NZ King Salmon Investments Limited ('NZK') – Trading Halt (9:03am, 13 April 2022)[201]
   NZKS FY22 results and NZ$60.1 million equity raising (1:39pm, 13 April 2022)[202]
4. NZKS completes rights offer (8:30am, 10 May 2022)[203]

Figure 11: Salmon dumped at landfill in Blenheim
Source: McGuinness Institute, Figure 46, *Discussion Paper 2022/02 – New Zealand King Salmon Case Study: A financial reporting perspective*[24]
Note: Data from MDC. This data was provided by an NGO, who requested this data from MDC.

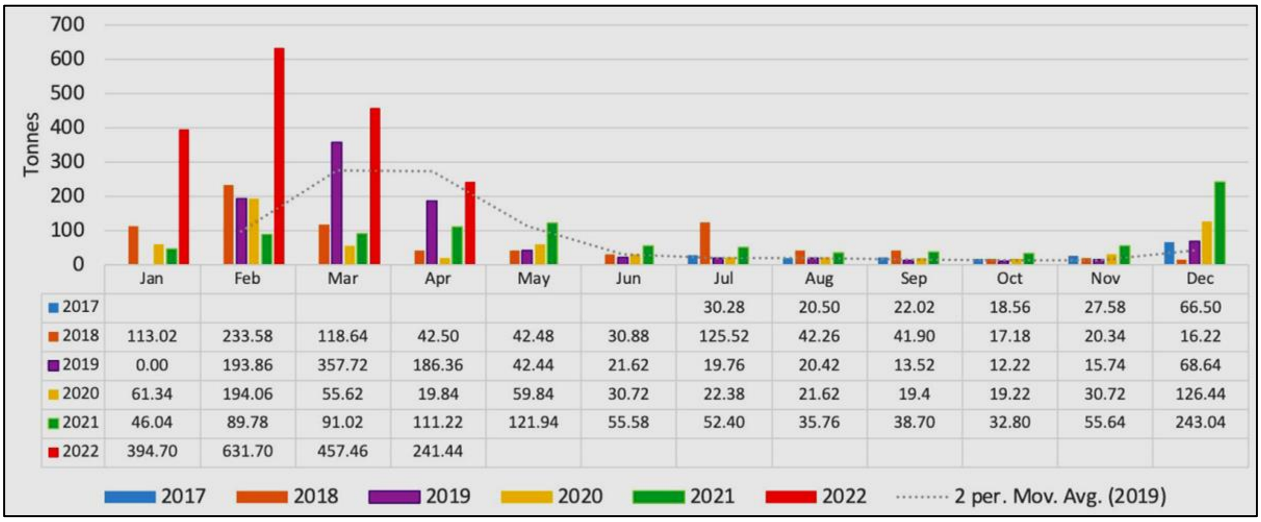
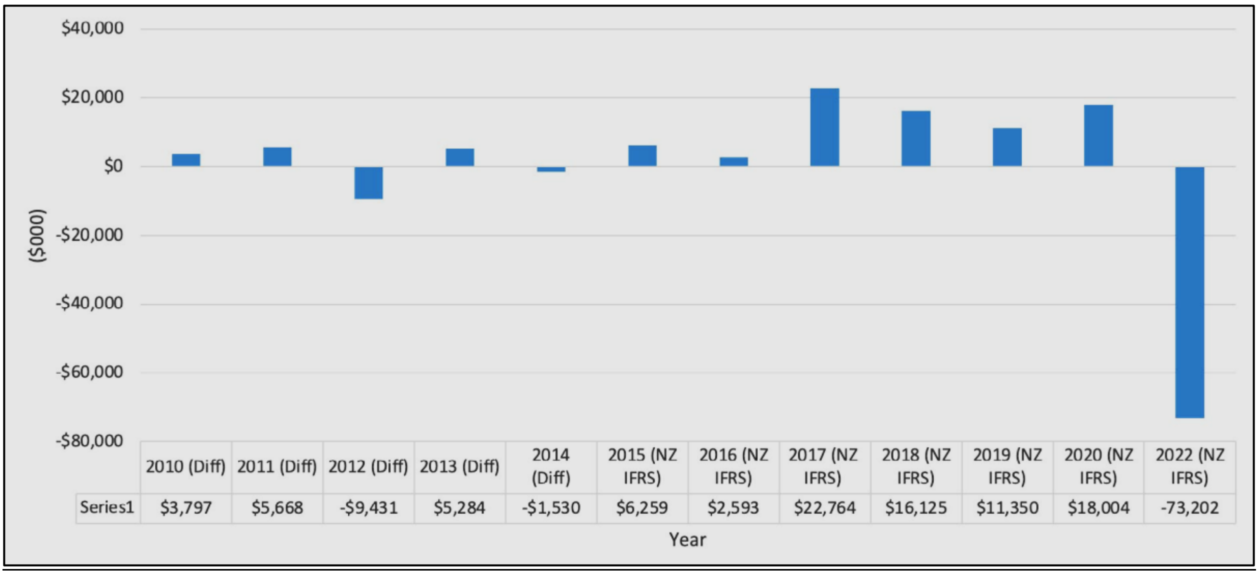


Figure 12: Net profit/loss after tax (NPAT/NLAT)
Source: McGuinness Institute, Figure 37, *Discussion Paper 2022/02 – New Zealand King Salmon Case Study: A financial reporting perspective*[25]



The distinction between GAAP and pro forma financials is important. Generally accepted accounting principles (GAAP) are a common set of accounting principles, standards and procedures issued by the Financial Accounting Standards Board (FASB).[26] The financial statements lodged by listed companies to the Companies Office must comply with GAAP and be audited by a qualified auditor.[27] The accountants of listed companies are required to follow GAAP when preparing financial statements.

In contrast, pro forma financials (also called non-GAAP or prospective financial statements) are not computed using standard GAAP and usually leave out one-time expenses that are not part of normal company operations. Essentially, a pro forma financial statement can exclude anything a company believes obscures the accuracy of its financial outlook.[28] This is why there is generally a requirement to reconcile a company's financial statements with GAAP financial statements.

The NZX *Listing Rules* (see Figure 13) states all announcements must be prepared in compliance with applicable Financial Reporting Standards. The Institute could not find out if this was required for announcements other than full-year and half-year results; however, if this is the case, it should be made clear in the *Rules* – that all announcements that include any financial information should comply with applicable Financial Reporting Standards only.

From the Institute's view, the results reported by NZKS were made to look as though they aligned with earlier forecasts, rather than alerting stakeholders and shareholders to a change in their financial position. This was due to the ability to treat an FX close-out, a one-time income, as an addition to their income and therefore, their pro forma NPAT. As we are sure you are aware, this is the problem with pro forma reporting; the company can largely report what it wants and there is no need to be transparent, apart from providing a reconciliation to GAAP results.

Figure 13: 2020 NZX Listing Rules, Appendix 2: Results Announcement
Source: McGuinness Institute, Figure 25, *Discussion Paper 2022/02 – New Zealand King Salmon Case Study: A financial reporting perspective*[29]

Full Year and Half-Year Results Announcement

All Results Announcements must comply with the following requirements:

1. All statements must be prepared in compliance with New Zealand equivalents to International Financial Reporting Standards issued by the External Reporting Board or the equivalent foreign accounting standards.
2. A statement of the accounting policies (if any) that the directors believe are critical to the portrayal of the Issuer's financial condition and results and which require the directors to make judgements and estimates about matters that are inherently uncertain.
3. If there has been any material change in accounting policies applied in preparation of the statements reflected in the announcement, it must disclose the impact of the change.
4. If the financial statements have been audited, a copy of the audit report should be provided with the announcement.
5. The announcement may include any additional facts, figures or interpretative notes that the Issuer wishes to include, and must include any additional information required by any applicable financial reporting standard or necessary to ensure the announcement is not misleading.

(ii) Concerns over the 'washing' of financial statements

Finding 1: Mortalities as a result of climate change were not the sole blame for a large loss in profitability.

Mortality (due to climate change) is portrayed as the major culprit for NZKS's loss in FY2022. However, there was also a number of other issues that together may have had a significant impact, for example, a feeding issue at Te Pangu farm, Tory Channel (linked to increased mortality, see Figures 11 and 14), and a major increase in freight costs to market. The increase in freight costs may have occurred as a result of the COVID-19 pandemic and/or a significant increase in sales to North America in the FY2022 (see Figure 15). In addition, banks and other investors may be developing a lower appetite for risk given the emerging financial crisis and the climate change crisis.

The goodwill, arising from business combinations of $39.3m, was fully impaired. The plant, equipment and fittings were impaired on a 'value in use calculation', using a discounted cashflow to estimate the recoverable amount of cash-generating units (CGUs). This resulted in $14.4m being impaired. Identifying CGUs is a critical step as it requires a high level of judgement given it may have a significant impact on the financial results. Given the limited information provided, the reader is reliant on the auditors to highlight all key audit matters in their report.

Figure 14: NZKS 2022 financial statements, Note 28: Events after balance date

Source: McGuinness Institute, Figure 3, *Discussion Paper 2022/02 – New Zealand King Salmon Case Study: A financial reporting perspective*[30]

28. EVENTS AFTER BALANCE DATE

On 1 February 2022 the Group disclosed a mortality event was occurring at its sea farms. This event has continued into February, March and April of FY23, which will impact the FY23 harvest and financial results. As a result of this mortality event the Group is:

- Undertaking a change to its farming strategy to reduce the mortality risk by not farming the warmer farms during the summer months.
- The Group will look to offset the loss in harvest with market and product optimisation in addition to traditional tools

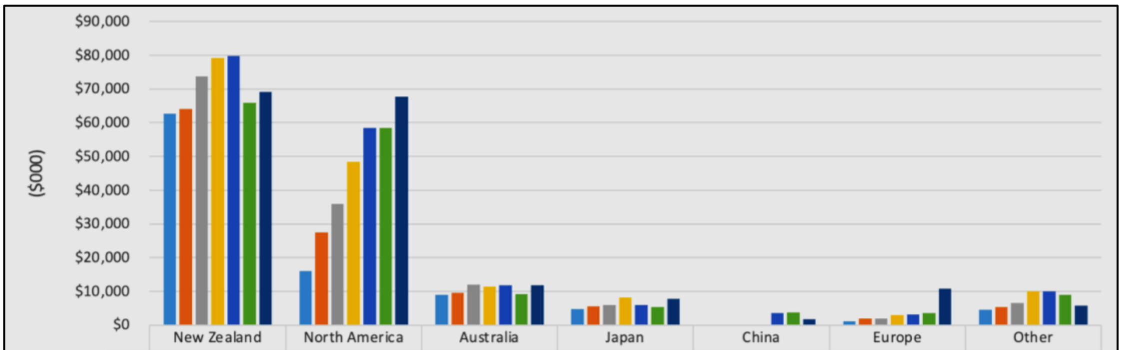
In addition to the mortality event which has occurred at our warmer sea farms over summer, the Group has also seen elevated mortality at one of its other sites, Te Pangu, which has been linked to a feed related issue. This issue will also result in a lower FY23 harvest and the expected financial impact of this post year end mortality event is an EBITDA loss of $3.8m

In February 2022 the Group also commenced discussions with the BNZ resulting in an extension to the delivery date for the 31 January 2022 covenants to 13 April 2022 and in any event on or before 30 April 2022 on the understanding that an equity raise will be launched on or about that date. The Group has modelled that breaches will occur without corrective action being undertaken. On 12 April 2022, the Group's Board approved to proceed with a fully underwritten or pre-committed equity raise of $60.1m. In addition, the Group has agreed a combination of temporary covenant waivers and temporary adjustments to covenant definitions with its debt providers. As a result of these corrective actions the Group has greater confidence that there will be no default event in respect of its financial covenants for 12 months from the date of approving these financial statements.

No final dividend was declared in respect of the year ended 31 January 2022 (7 months to 31 January 2021: Nil).

Figure 15: Revenue by geographical location of customers

Source: McGuinness Institute, Figure 33, *Discussion Paper 2022/02 – New Zealand King Salmon Case Study: A financial reporting perspective*[31]



	New Zealand	North America	Australia	Japan	China	Europe	Other
2015	$62,773	$15,928	$8,956	$4,804		$1,215	$4,612
2016	$64,107	$27,419	$9,642	$5,552		$1,926	$5,414
2017	$73,824	$35,956	$12,035	$6,034		$1,986	$6,516
2018	$79,226	$48,435	$11,497	$8,265		$2,860	$9,988
2019	$79,759	$58,479	$11,862	$5,893	$3,591	$3,117	$9,908
2020	$66,003	$58,432	$9,280	$5,275	$3,746	$3,625	$8,981
2022	$69,085	$67,626	$11,816	$7,807	$1,737	$10,709	$5,750

■ 2015 ■ 2016 ■ 2017 ■ 2018 ■ 2019 ■ 2020 ■ 2022

Finding 2: The mortalities labelled 'unforeseen' should not have been completely unexpected.

The board and the management, in both the FY2022 financial statements and 2022 Offer Document, made it clear that the reason for the liquidity issues and the loss was unforeseen mortality. The statement that refers to 'unforeseen mortalities' can be found in Note 20: Interest bearing loans and borrowings. It states:

> The impacts of the **unforeseen** mortalities **resulted in the Group breaching** a number of its bank related covenants as at 31 January 2022 and forecasting to be in breach of the following covenants in the next 12 months. … As a result … the Bank has agreed in principle to a combination of temporary covenant waivers, renegotiation of facilities and adjustments … on the basis the Group completes an equity raise of a minimum of $50m (net of transaction costs). [bold added]

Other key information includes:

Mortality/mortality rate is defined in the 2022 annual report (p. 107) as:

> The percentage mortality of salmon in seawater, calculated as the biomass of salmon mortalities in kg divided by the growth of salmon in kg.

A 2017 Ministry of Primary Industries (MPI) Intelligence Report, *MPI Technical Paper No. 2017/39* (p. 7), states:

> As with all farmed animals, mortality occurs throughout the farmed salmon lifecycle. NZKS expect a mortality rate of approximately 25%.

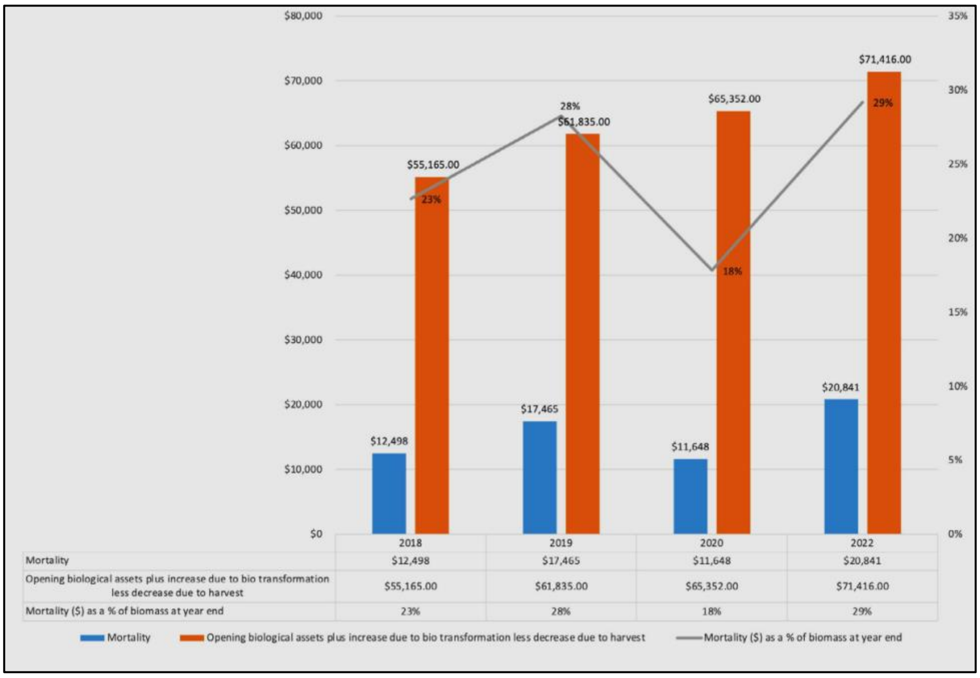
Mortalities are not new to NZKS, nor is the level of mortalities when comparing FY2022 with previous years. Figure 16 (overleaf) compares mortality against biomass at year end, and found 29% in FY2022 and 28% in FY2019. Based on our calculations, there is little difference between FY2022 and FY2019.

Further, using our calculations, the average over four years (2018, 2019, 2020 and 2022) is 24.5%. This aligns with the 25% mortality rate quoted by MPI in 2017.[32]

Figure 16: Mortality as a percentage of biomass at year end
Source: McGuinness Institute, Figure 36, *Discussion Paper 2022/02 – New Zealand King Salmon Case Study: A financial reporting perspective*[33]

Note 1: Compares 12-month financial years only.

Note 2: The percentage of mortalities is calculated by dividing mortalities into the total of (i) biological assets (opening balance), (ii) bio transformation over the 12-month period and (iii) harvest over the 12-month period. We were unable to recalculate NZKS 2022 mortality rates using the definition found in the 2022 annual report (see discussion in Questions 1 and 2).



	2018	2019	2020	2022
Mortality	$12,498	$17,465	$11,648	$20,841
Opening biological assets plus increase due to bio transformation less decrease due to harvest	$55,165.00	$61,835.00	$65,352.00	$71,416.00
Mortality ($) as a % of biomass at year end	23%	28%	18%	29%

2.5 Report 17 – ReportingNZ: Building a Reporting Framework Fit for Purpose[34]

This report brought together the McGuinness Institute's research into and analysis of the New Zealand reporting framework with three main goals. Firstly, it provided an overview of the Institute's research findings and analysis to date as at June 2020, evidencing what is working and not working with the current system. Secondly, it provided observations and recommendations for policy-makers and other interested parties on how the current system could be improved. In undertaking this, the Institute found that the current reporting framework was outdated, stagnant, inflexible and, arguably, costly and unlikely to be responsive to the future needs of shareholders and other stakeholders. Therefore, the third aim of this report was to lay the groundwork for a comprehensive review of New Zealand's reporting framework.

Finding 1: It is not always clear where the income tax of multinationals operating within New Zealand is being paid.

As part of the preliminary work for Report 17, *Working Paper 2018/01 – NZSX-listed Company Tables*[35] looked at many different types of information provided in the 2016 annual reports of NZSX-listed companies, including the disclosure of tax paid. Analysis of the annual reports found that nine listed companies are overseas ASIC or overseas non-ASIC companies, meaning that they do not need to comply with New Zealand accounting standards. These companies include Westpac Banking Corporation, ANZ and Downer EDI Limited, whose size in terms of revenue and assets are significantly greater than most New Zealand companies. In New Zealand, companies are not required to disclose amounts of tax paid on a country basis.

For example, the 2019 annual report for Westpac Banking Corporation (Australia) disclosed AUD$3,406 million in income tax, while the New Zealand subsidiary paid a total of NZD$373 million.[36] However, it is unclear how much of the income taxes paid by the parent or the subsidiary went to the New Zealand Government.

For example, it was reported in March 2017 that Apple New Zealand Limited had not paid income tax to Inland Revenue (IRD) for the previous decade and their accounts revealed that any income tax paid had been passed to the Australian Tax Office. This is a result of The Avoidance of Double Taxation treaty between Australia and New Zealand, in place since 2007, which permits companies to only pay tax where the company is controlled. As Apple Sales New Zealand is wholly owned by the Australian parent company, the income tax defaults to Australia.[37]

As an act of transparency, multinational corporates who own operations within New Zealand should be making disclosures that acknowledge these operations and state the relevant tax paid. Disclosing the actual amount of tax paid will also benefit the IRD, which can then check the entity's tax return against the amount shown in the annual report or in the audited Statement of Cash Flows. Ryman Healthcare Limited's annual report for FY2021 provides an example of a simple disclosure that states tax paid in both New Zealand and Australia (see Figure 17 overleaf).

Companies and other organisations are increasingly under the spotlight in terms of whether they are paying tax and, if so, what country receives the cash payment (i.e. are overseas companies that operate in New Zealand paying tax to the New Zealand Government or to other countries with possibly lower tax rates?). If entities are operating in New Zealand but both their profits and taxes are going offshore, socially responsible investors and other stakeholders may be interested in this information and may make investment decisions accordingly.

Figure 17: Ryman Healthcare Limited 2022 financial statements, Note 4: Income tax
Source: Ryman Healthcare Limited, Annual Report 2021[38]

RYMAN HEALTHCARE

Notes to the consolidated financial statements (continued)

FOR THE YEAR ENDED 31 MARCH 2021

4. INCOME TAX

a. Income tax recognised in income statement

	2021	2020
	$000	$000
Tax expense comprises:		
Current tax expense	-	-
Deferred tax credit	(12,561)	(93,563)
Total income-tax credit	**(12,561)**	**(93,563)**

The income-tax expense on pre-tax accounting profit from operations reconciles to the income-tax expense in the financial statements as follows.

	2021	2021	2020	2020
	$000	%	$000	%
Profit before income-tax expense	410,500		171,147	
Income-tax expense calculated at 28%	114,940	28.0%	47,921	28.0%
Tax effect of:				
Non-taxable income	(116,717)	(28.4)%	(40,443)	(23.7)%
Property temporary differences	15,502	3.8%	(65,771)	(38.4)%
Tax losses recognised	(45,122)	(11.0)%	(49,967)	(29.2)%
Other	18,836	4.6%	14,697	8.6%
Total tax credit	**(12,561)**	**(3.0)%**	**(93,563)**	**(54.7)%**

Non-taxable income arises principally from the fair-value movement of investment property.

The tax rate used in the above reconciliation is the corporate tax rate of 28 percent (2020: 28 percent) payable by New Zealand corporate entities on taxable profits under New Zealand tax law. The corporate tax rate in Australia is 30 percent (2020: 30 percent).

Total Group tax losses available in New Zealand amounted to $410.7 million (2020: $289.5 million). Recognition of the deferred tax asset is based on expected taxable earnings in future periods. There are no unrecognised tax losses in New Zealand (2020: $Nil).

Total tax losses available in Australia amounted to AUD$105.8 million (2020: AUD$71.3 million). Recognition of the deferred tax asset is based on expected taxable earnings in future periods. There are no unrecognised tax losses in Australia (2020: AUD$Nil).

3.0 Recent Developments, Events and Ideas

3.1 United Nations Environment Programme (UNEP) latest climate report

Finding 1: The situation is urgent.

The October report *Emissions Gap Report 2022: The Closing Window – Climate crisis calls for rapid transformation of societies* states:

> The report shows that updated national pledges since COP26 – held in 2021 in Glasgow, UK – make a negligible difference to predicted 2030 emissions and that we are far from the Paris Agreement goal of limiting global warming to well below 2°C, preferably 1.5°C. Policies currently in place point to a 2.8°C temperature rise by the end of the century. Implementation of the current pledges will only reduce this to a 2.4-2.6°C temperature rise by the end of the century, for conditional and unconditional pledges respectively.
>
> The report finds that only an urgent system-wide transformation can deliver the enormous cuts needed to limit greenhouse gas emissions by 2030: 45 per cent compared with projections based on policies currently in place to get on track to 1.5°C and 30 per cent for 2°C. This report provides an in-depth exploration of how to deliver this transformation, looking at the required actions in the electricity supply, industry, transport and buildings sectors, and the food and financial systems.[39]

3.2 Patagonia, the company

Finding 1: Owners are looking for new ways to contribute to the challenges the planet faces.

Yvon Chouinard, founder of Patagonia, discusses in his recent letter how the business has been restructured to create a durable model that aligns its purpose with its values. In mid-September 2022 the current owners decided to transfer ownership of 98% of the company and all its nonvoting stock to the Holdfast Collective (a not-for-profit organisation). The remaining 2%, and all voting stock, was transferred to the Patagonia Purpose Trust (a trust). The Collective will act as the financer, investing excess profits made by Patagonia into combatting our environmental crisis, while the Trust will act as steward in protection of this cause and uphold Patagonia's values by guiding key company decisions.[40] Their website notes:

> **Who owns Patagonia?**
> Patagonia's new owners are the Holdfast Collective and the Patagonia Purpose Trust. The Holdfast Collective owns 98% of the company and all of the nonvoting stock. The Patagonia Purpose Trust owns 2% of the company and all of the voting stock. Nonvoting stock carries economic value but not decision-making authority. Voting stock has both economic value and decision-making authority.
>
> **What is the Holdfast Collective and what does it do?**
> The Holdfast Collective (Collective for short) will use every dollar received to fight the environmental crisis, protect nature and biodiversity, and support thriving communities, as quickly as possible. As a 501(c)(4) not-for-profit organization, the Collective can advocate for causes and political candidates in addition to making grants and investments in our planet. Funding for the Collective will come from Patagonia: Each year, excess profits—money we make after reinvesting in the business (including money we want to save for unforeseen events, like a pandemic)—will be distributed as a dividend to the Collective to be used for its work.
>
> **Does this make Patagonia a non-profit?**
> No. Patagonia continues to be a for-profit business, a certified B Corp and a California benefit corporation, making the best-quality products and honouring its obligation to preserve the financial health of the company while always considering the impact our business has on employees, customers and communities—and on the health and vitality of the natural world. Our impact in the world comes from operating as a for-profit business. We will continue to serve as a beacon for the entire business community by proving that purpose and profits are inextricably linked.
>
> This means the for-profit company is owned by a not-for profit and a trust (purpose), hence their PR statement that the 'Earth is now our only shareholder'. The combination of a for-profit, not-for profit and a trust is not new, but perhaps the scale and role of the trust (as the steward for the planet) is novel.

However, it is Chouinard's statement that continues to shape our thinking: 'We needed to find a way to put more money into fighting the crisis while keeping the company's values intact…. Truth be told, **there**

were no good options available. So, we created our own' [emphasis added].[41] Hence the creation of three interconnected entities.

Our view is that there will evolve over time a business model that sits between a for-profit company and a not-for-profit. The history of these terms, as we understand it, is that if a company was not 'for-profit', it became a 'not-for-profit' – in other words 'not-for-profit' is used for everything else. The Patagonia example illustrates how owners are finding ways to meet the wider stakeholder interest.

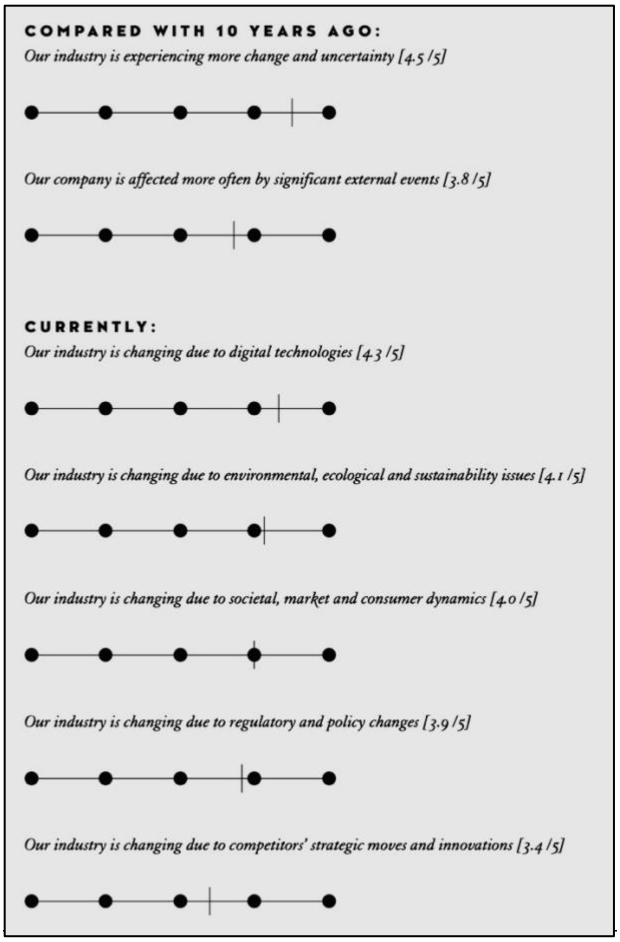
3.3 Aarhus University School of Management and the Copenhagen Institute for Future Studies report: *Organizational Future-preparedness after COVID-19: A Clearer Role for the Board?*[42]

The report *Organizational Future-preparedness after COVID-19: A Clearer Role for the Board?*, published in November 2021, analyses the role of directors of boards in achieving and maintaining organisational future-preparedness, and the balance that exists between the directors and their management executives. The report illustrates findings from 25 in-depth interviews with the non-executive directors and board chairs of listed European companies covering different sectors.

Finding 1: Board members recognise high levels of external change and uncertainty in the environment of their industry and believe they have a role in preparing their companies for change.

When the board members were asked if conditions, both externally and within their industries, were changing rapidly and significantly, and as a result affecting the company, most of them said yes (see Figure 18 below).

Figure 18: Responses of board members in relation to external uncertainty and future-preparedness
Source: Copenhagen Institute for Future Studies, *Organizational Future-preparedness after COVID-19: A Clearer Role for the Board?*[43]



They were then asked if the board had a role in managing their company's preparedness for these changes, and all agreed that it did.

Finding 2: Out of an identified six methods of company future-orientation, all board members reported themselves as having been involved in one or more of the following:

(i) Enterprise risk management
Directors reported consistent focus within areas of business continuity, including disaster anticipation and recovery planning, particularly reviewing the adequacy of management's resilience plans. It was reported that subcommittees, particularly finance and audit committees, had discussed risk management. In several cases it was noted that these discussions included potential new business opportunities and alliances.

(ii) Annual strategy session
All board members reported future-preparedness and planning occurring in one or more company management strategy sessions. These events typically happened once a year and often introduced views from external sources such as clients or customers, or external technology or sector experts. In a few cases these sessions led to formal board items for follow-up, but most did not.

(iii) Self-education
Board members reported following a self-guided path towards increased awareness of external and industry change. Methods included reading widely, travelling, attending events, seeking expert opinions and talking to knowledgeable people, particularly about topics pertinent to their industry.

(iv) Mergers and acquisitions (M&A) prospecting
The directors noted direct involvement, of either themselves or a colleague, in research towards company mergers or acquisitions. The report suggests this is an action of future-preparedness as acquiring new capabilities or markets, or increasing firm size and scope, could provide security and

longevity. The report also notes early-stage M&A prospecting is seen as a traditional board-member function because directors often have the industry reach and contacts necessary for this.

(v) Management succession planning
Board members considered not only present executive management capability as important in the future-preparedness of the company, but the future pipeline of senior management talent too.

(vi) Board renewal and diversity
The composition of the board, and its renewal, was also considered important in the future-preparedness of the company. This included increasing a range of competencies, experience and backgrounds – as well as increasing diversity in terms of gender, age, ethnicity and national background.

Regarding board diversity (see point (vi) above), the Institute would like to acknowledge recent events in California. On 30 September 2020, the Californian Governor, Gavin Newsom, legislated a bill that 'had been championed as an effective means for remedying the lack of diversity on the boards of directors of California-based companies'.[44] The legislation required the boards of directors for publicly held California-headquartered companies to have a minimum number of ethnically and racially diverse or LGBT members – referred to as people from 'underrepresented communities' – on their boards of directors.[45] Specifically, the 'number of directors from underrepresented communities [needed to] increase by the end of 2022 to two directors for boards with more than four but fewer than nine directors and to three directors for boards with at least nine directors'.[46] However, on 1 April 2022, the Superior Court of California found this legislation to be unconstitutional and 'struck down' the requirement.[47]

The issue of homogenous boards (e.g. boards that consist of one race, sexual orientation and gender identity) undoubtedly continues to exist. Homogenous boards run the risk of falling victim to stagnant thinking, unchallenged assumptions and inflexible responses to challenges – which can ultimately lead to poor decision making, less innovation, and less profit,[48] therefore, suggesting the solution is simply heterogenous boards. While mandating heterogenous boards seems like an easy fix, as illustrated by the United States example above, the reality is that for some countries it may be unconstitutional.

Investor priorities and expectations are perhaps the strongest drivers of shifting business practices, but that requires good quality reporting to be effective. A better role for legislation would be to ensure that any groups of qualified individuals stand upon neutral and unbiased grounds – where all demographics have an equal chance of success.[49]

Finding 3: Board members considered that the practices of strategic foresight used would achieve merely adequate future-preparedness.

Given both the wide acknowledgement of the rapid external and industry-based changes and the boards' role in preparing for this, and the practices listed above, board members were asked whether the current type and level of their practices were satisfactory. See Figure 19.

Figure 19: Board members' evaluation of board practices in company future-orientation
Source: Copenhagen Institute for Future Studies, *Organizational Future-preparedness after COVID-19: A Clearer Role for the Board?*[50]

RESPONSES TO THE PROPOSITIONS WERE:

Our board's level of engagement (time, attention, focus) is sufficient, in regard to external uncertainty and industry change facing the company/organization. [3.2 /5]

Our board structure, committees, roles and tasks are well-aligned to navigating external uncertainty and industry change. [3.6 /5]

The report closes by providing two key initiatives for directors aiming to hone the board's role in future-orientation and future-preparedness. The six methods of company future-orientation previously mentioned were accompanied by a seventh practice of non-predictive foresight:

> [I]ncorporate strategic foresight methods to create a high-quality view of industry or sector evolution. Such methods are entirely unrelated to forecasting or modelling, which are brittle to even minor changes in the external environment, and therefore intrinsically unreliable and often directly misleading. Rather, enhanced future-industry judgment is achieved by comprehensive scanning and [cataloguing] of change-indicators, including awareness of cognitive framing and other judgmental biases; and on this basis formulating alternative plausible templates of external future operating environments for leadership discussion and decision. Such envelopes of plausible evolution will simultaneously account for technology, market, regulatory and competitor developments, as well as the feedback effects among these. They allow an organization's current or near-term strategy choices to be critically evaluated against a spectrum of forward views of industry conditions. Doing this consistently and authentically invites productively dissonant points of view, therein also demands that leadership nurtures a culture which rewards this, and which strives to balance today's priorities with value-stewardship. Upon such platforms and methods, exercised consistently over time, a higher-quality judgment of the pace and direction of industry change can be built and used.[51]

3.4 The Wirecard scandal and the impact on auditor independence

In June 2020 the German financial technology company Wirecard AG became the centre of financial news as the company collapsed after its longstanding auditor (EY) refused to sign off Wirecard AG's accounts as it could not answer for a missing 1.9 billion euros. The elaborate timeline of fraud and deception committed by Wirecard AG dates back to 2008, with early sceptics unsure how the company was generating the revenue it claimed, and marks itself as one of Germany's biggest financial scandals.[52,53]

In order to restore confidence after the Wirecard scandal, the German legislator passed an Act to Strengthen Financial Market Integrity, or FISG for short. FISG came into force on 1 July 2021. The Act has tightened regulations on financial reporting and corporate governance, in particular creating stricter rules for companies and their auditors.[54] Two of these are relevant to this consultation.

(i) Changes to the mandatory firm rotation (MFR) for auditing

Although the FISG continued to follow the mandatory firm rotation (MFR) period of 10 years for audit firms (set out in the 2014 reforms to the EU Statutory Audit Directive), it tightened the earlier framework by:

- extending MFR to other participants (not just public interest entities (PIEs)). This meant that the 10-year rule was extended to include all financial market participants such as credit and financial services institutions and insurance companies.
  Note: In June 2016, the EU regulatory framework for statutory audit required PIEs within the EU to rotate auditing firms every 10 years, with the member state extending this period a further 10 years if a tender was undertaken, or a further 14 years if joint auditing was adopted[55]
- no longer allowing any extensions beyond the 10-year rotation
- reducing the maximum amount of time from 10 years to five years before an internal audit partner, responsible for the statutory audit of PIEs, must also be rotated to five years.

(ii) Adjustments to providing non-audit services in order to reduce conflict of interest

The FISG also introduced stricter regulations on the provision of auditing services with other non-audit services (often referred to as NAS). The FISG prevented PIEs from incorporating concurrent auditing, tax advice, or assessment services. Auditors who breach these prohibitions face fines upwards of €500,000, and auditing firms can be sanctioned, including fines reaching €5 million, if prohibited services are provided.[56]

Note: In June 2016, the EU regulatory framework for statutory audit introduced restrictions on non-audit services provided to a PIE statutory audit client, its EU parent, or its EU-controlled subsidiaries, and a fee cap for the remaining permissible NAS. These restrictions included prohibitions on provision of certain tax services, services that involve partaking in management or decision making, and certain legal services.[57] The fee cap is calculated as 70% of the average statutory audit fees over the previous three years. Interestingly (as has happened in the FISG case), member states are allowed to add additional NAS prohibitions and adopt legislation that further restricts NAS as they see fit but are not allowed to reduce the baseline list of prohibitions.[58]

3.5 Systematic risks and the impact on the business model

Generally, in the last three years, the world has experienced the amalgamation of many systematic risks playing out in unison. The COVID-19 pandemic was the pivotal 'identifier' or 'stress tester' of how systematic risk can (very suddenly) have deep and connected impacts that ripple throughout social, economic, and political systems across the world. And yet, while lessons are still being learnt from COVID-19, another event, equally shocking (in terms of impact) has asserted itself – the Ukraine war. The wider implications and uncertainty of the Ukraine war on global supply chains, financial markets, food security and geopolitical stability are all similar in nature to the impact of COVID.

The scale of subsidies and bail-outs across the Government's response to COVID-19 signals an area that the Institute believes to be pertinent toward future-proofing accounting practice. Given the impacts that the Ukraine war is having on global supply chains, financial markets, food security and geopolitical stability, the Institute believes that a similar response may unfold from the Government (though perhaps not at the same scale). Therefore, the Institute asks the NZX the question – how do we account for bail-outs in difficult times?

3.6 The growing gap between market value of a company and their asset value in financial statements

The Institute remains concerned with the observation of asset values (as reported in financial statements) being increasingly out of line with market values. Business models are currently undergoing substantial change. This is evidenced by the move away from tangible assets towards more intangible asset market values, which are more volatile, less certain, and therefore harder to value. Reputation is an increasingly important asset for organisations to manage.

As part of the Institute's *Report 17 – ReportingNZ: Building a reporting framework fit for purpose,* the Institute analysed the tangible and intangible asset values of 110 NZSX-listed companies in 2017. It was found that NZSX-listed companies, as a group, had followed international trends, in that asset value does not equate market value. This disparity has arisen primarily because of the requirements of current accounting standards where only certain intangible assets are recorded in the financial statements (e.g. goodwill) while others are not (e.g. the value of the company's brand), which makes finding an accurate value of a company's intangible assets a difficult task.

The issue is that the system is selling the concept to users that financial statements accurately represent the financial positions of companies when this is not the case (as seen above). Furthermore, legislation requires (i) boards to prepare financial statements (see Financial Reporting Act 2013, box 1) and (ii) directors to sign off financial statements (see Companies Act 1993, box 2) in accordance with GAAP – implying that the statements are prepared and signed off to represent a 'true and fair view' of the value of a company. The question is not whether the gap between asset value and market value exists; the question then becomes – what is the acceptable threshold for such a gap? To increase this transparency, the Institute suggests that the NZX, as part of the *Corporate Governance Code*, requires the disclosure of market value in financial statements. This would make it morally acceptable for directors to sign off as there is a distinction.

Below, the Institute wishes to provide an excerpt from *Report 17* to provide further context regarding the above discussion.

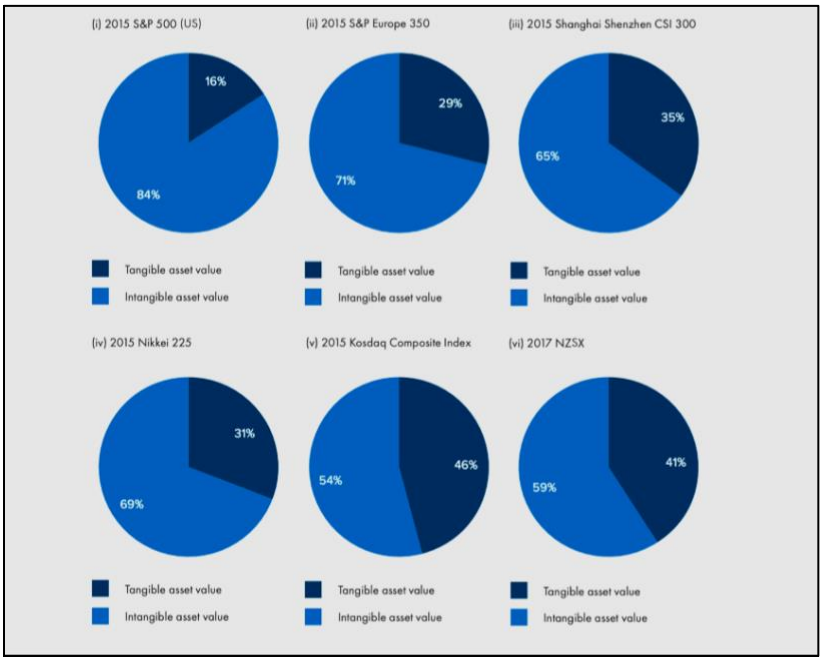
(a) Comparison of New Zealand and international equity markets

Figure 20 (vi) presents the 2017 tangible and intangible asset values of NZSX-listed companies, enabling comparisons with other international equity markets using Ocean Tomo's 2015 data. The NZSX had an average tangible asset value of 41% and average intangible asset value of 59%. However, not all companies were similar in terms of tangible and intangible asset values. There were many cases where a company had a negative tangible/intangible asset value (and as a result one percentage would be negative and one would be over 100%), indicating a company's value depended highly on their tangible/intangible assets. For example, New Zealand Oil and Gas Limited (a mining company) has a tangible asset value that is 136.18% of market capitalisation (and thus an intangible asset value of -36.18% of their market capitalisation), meaning the company is highly dependent on tangible assets. By contrast Trade Me Group Limited (an information technology company) has an intangible asset value of 104.35% of their market capitalisation.

Figures 20 (i) and (ii) indicate that the percentage of NZSX's average tangible asset value is higher than the American and European equity markets in 2015 and 2017 respectively. The NZSX aligns more closely with the Asian markets (Figures 20 (iii) to (vi)), which have tangible asset values between 31% and 46%. Although the comparable data is from 2015, it indicates that the New Zealand equity market has a higher tangible asset value than its international counterparts. There may be several reasons for this; international markets may have more companies in sectors that depend on intangible assets. The S&P 500 (an American stock market index) tends to list companies in sectors whose value comes primarily from intangible assets, such as information technology (e.g. Apple, Facebook and Microsoft) and healthcare (e.g. Johnson & Johnson, Pfizer Inc. and Cigna), with these two sectors alone making up 40% of the S&P 500.[59] The NZSX, on the other hand, may have more primary industry and property companies, which are both heavily dependent on tangible assets and/or may be due to New Zealand companies tending to revalue their assets more frequently.

Figure 20: Comparing intangible asset market values of international equity markets (2015) with the New Zealand equity market (2017)

Source: McGuinness Institute, *Report 17 – ReportingNZ: Building a reporting framework fit for purpose*[60]



Box 1: Companies Act 1993 (s 201)

201 Financial statements must be prepared

Every company or overseas company to which this section applies (A) must ensure that, within 5 months after the balance date of A, financial statements that comply with generally accepted accounting practice are—

(a) completed in relation to A and that balance date; and

(b) dated and signed on behalf of A by 2 directors of A, or, if A has only 1 director, by that director.

Compare: 1993 No 106 ss 10(1), 11(1)

Section 201: replaced, on 1 April 2014, by section 30 of the Financial Reporting (Amendments to Other Enactments) Act 2013 (2013 No 102).

Box 2: Financial Reporting Act 2013 (s 12)

12 Functions of Board

The Board has the following functions:

(a) to prepare and, if it thinks fit, issue financial reporting standards for the purposes of any enactment that requires —

(i) financial statements or group financial statements to comply, or be prepared in accordance, with generally accepted accounting practice or non-GAAP standards; or

(ii) a statement, report, or other information to comply, or be prepared in accordance, with financial reporting standards:

(aa) to prepare and, if it thinks fit, issue climate standards for the purposes of any enactment that requires climate statements or group climate statements, or a statement, report, or other information to comply, or be prepared in accordance, with the climate-related disclosure framework:

(b) to prepare and, if it thinks fit, issue auditing and assurance standards for—

(i) the purposes of the Auditor Regulation Act 2011 or any other enactment that requires a person to comply with those standards; or

(ii) the purposes of any rules or codes of ethics of an association of accountants where those rules or codes require the association's members to comply with those standards; or

(iii) any other purpose approved by the Minister by notice in writing to the Board:

(c) to prepare and, if it thinks fit, issue authoritative notices for the purposes of—

(i) the definition of generally accepted accounting practice; or

(ii) the definition of climate-related disclosure framework:

(d) to develop and implement strategies for the issue of standards in order to provide a framework for the Board's overall direction in the setting of standards (including implementing a strategy for tiers of financial reporting in accordance with sections 29 to 33):

(e) to liaise with international or national organisations that perform functions that correspond with, or are similar to, those conferred on the Board:

(f) to perform and exercise the functions, duties, and powers conferred or imposed on it by or under this Act and any other enactments.

Compare: 1993 No 106 s 24(1)

Section 12(aa): inserted, on 28 October 2021, by section 37(1) of the Financial Sector (Climate-related Disclosures and Other Matters) Amendment Act 2021 (2021 No 39).

Section 12(c): replaced, on 28 October 2021, by section 37(2) of the Financial Sector (Climate-related Disclosures and Other Matters) Amendment Act 2021 (2021 No 39).

3.7 Harvard Business Review (2017) – The Board View: Directors Must Balance All Interests[61]

Reporting (and assurance) has traditionally been designed to create trust and confidence between shareholders (owners), the board (the governance body) and the CEO and management (the operators). The observation that the balance of powers shift over time was discussed by Barbara Hackman Franklin, 29th US Secretary of Commerce and chair emerita of the National Association of Corporate Directors, in a 2017 *Harvard Business Review* interview. To the question 'Do you agree that excessive focus on shareholders has become a problem?', Franklin responded with the following:

> I have always viewed it as a tripartite system of checks and balances. Shareholders own shares and elect the board of directors. The board of directors sets policies and hires and fires the CEO. The CEO and management run the company. The power balance among those three parties ebbs and flows over time, but there's always some balance. When I first joined boards of large public companies, three decades ago, CEOs were dominant. Then boards began to assert themselves, and the balance shifted toward them, particularly after Sarbanes-Oxley [a US law to protect investors from corporate accounting fraud] was passed in, in 2002. The balance has shifted again in the past five or six years, toward shareholders.
>
> But there's an added complication, which is activist shareholders, and their increased presence seems to me different from the normal ebb and flow among the three parties. Different and more worrying. This has been a new thing over the past few years. So I agree that the power should now shift back from shareholders and move towards boards and management.[62]

The activist shareholder is not a shareholder in the usual sense, but a new and dynamic element – they tend to represent a wider stakeholder and actively become a shareholder to disrupt the current direction, actions, or responsibilities of the business model. They do this because they have not been able to find other ways to be heard by the business.

Although the term 'stakeholder' dates back to 1708,[63] it is now frequently used to refer to those that have a stake but not necessarily a share in the business. We are currently experiencing an evolution in the way we think about those that have an interest in the activities of a business.

At the same time, we are seeing a change in owners' expectations. Exploring previously unknown business models and the creation of completely new ones are beginning to be thought of as feasible, if not necessary, in order to enable a thriving planet.

3.8 BlackRock Incorporated

BlackRock Incorporated's CEO Larry Fink created somewhat of a culture war with his 2022 annual letter to CEOs titled *The Power of Capitalism*.[64] The letter, which touches on topics such as stakeholder capitalism, ESG standards, and a world of net carbon zero was opposed by certain fossil fuel-producing US states, such as West Virginia,[65] concerned that the firm's net zero investment strategies threaten both investors and the economy, particularly amidst an ongoing global energy crisis.

BlackRock has always claimed to pursue an ideology of sustainable investing, commitments to ESG, and net zero. Larry Fink noted in his 2020 letter to CEOs:

> In a 2020 letter to our clients today, BlackRock announced a number of initiatives to place sustainability at the cent[re] of our investment approach, including: making sustainability integral to portfolio construction and risk management; exiting investments that present a high sustainability-related risk, such as thermal coal producers; launching new investment products that screen fossil fuels; and strengthening our commitment to sustainability and transparency in our investment stewardship activities.[66]

Strategies such as those mentioned above continue to be noted as a priority for BlackRock, in turn creating strong tensions between the company and those who do not follow so strongly in pursuing improved ESG reporting. The tensions created led to a response from a coalition involving 19 states, led by Arizona Attorney General Mark Brnovich, claiming BlackRock is putting its political agenda ahead of clients' best interests by 'pushing "comprehensive efforts to retire fossil fuels" and possibly violating "multiple state laws" through its "actions on a variety of governance objectives"'.[67]

In response to this, BlackRock stated they '"[do] not boycott energy companies or any other sector or industry," and insisted that the company's "engagement and voting around climate risk does not require that companies meet specific emissions standards"'.[68] In doing so, they contradicted their own policies and strategies, and exacerbated the existing tension with those that rely on its stewardship in fighting the climate crisis – so much so as to receive criticism from the New York City Comptroller, Brad Lander.

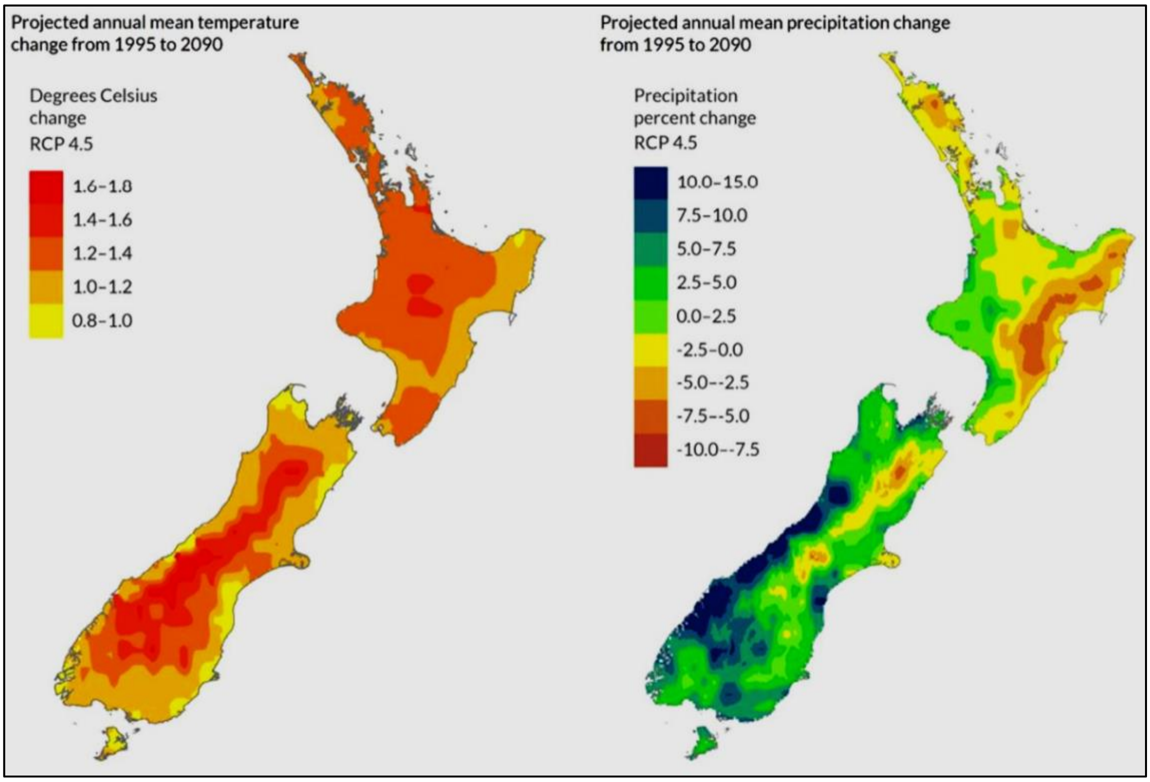
Lander describes the direct contradiction of BlackRock's statements and actions as 'alarming', noting that 'BlackRock cannot simultaneously declare that climate risk is a systemic financial risk and argue that BlackRock has no role in mitigating the risks that climate change poses to its investments by supporting decarbonization in the real economy'.[69] Given BlackRock's position as the world's largest asset manager and the corporate governance responsibilities placed upon it, it is time for the company to 'lead in deeds, not simply words'. [70]

3.9 The IPCC's Sixth Assessment Report

Finding 1: There has been a change in the language of climate impacts

The IPCC Sixth Assessment Report *Climate Change 2022: Impacts*, *Adaptation and Vulnerability* records a change in language in the terms of climate impacts . Previously climate impacts were discussed in an unintegrated and siloed manner, in terms of hotter/colder/wetter/drier (see for example the map of New Zealand in Figure 21). However, in 2022, the IPCC discussed compounded events (defined in Section 2.2) in more detail and discussed future climate impacts in terms of magnitude, frequency, locations, different timing and new combinations (see Figure 3).[71]

Figure 21: Temperature and precipitation climate change projections for New Zealand
Source: Ministry for the Environment (MfE), Figure 25, *Our atmosphere and climate 2020*[72]



3.10 Directive 2014/95/EU by the European Union

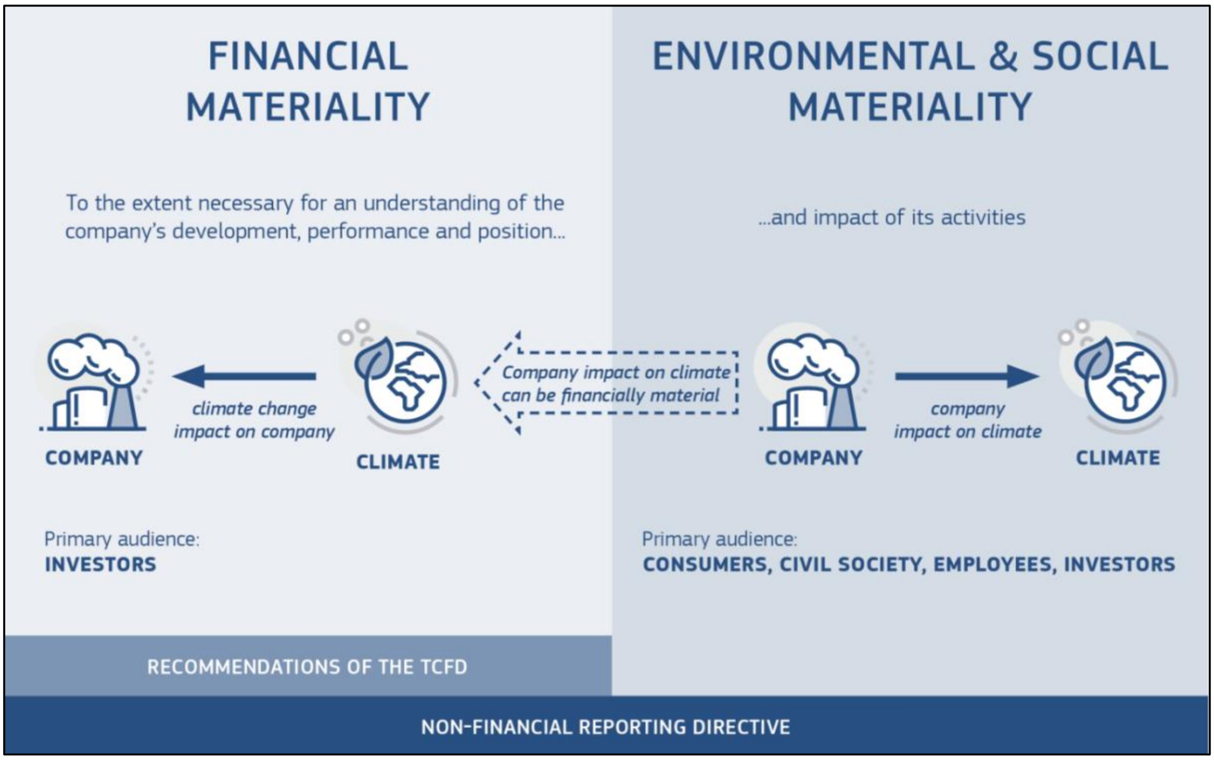
Finding 1: Companies and financial institutions also need to understand and address the negative impacts that their business activities have on the climate

While companies and financial institutions are becoming more accustomed to reporting the risks that climate change has on their businesses, the European Union argues that a stance of 'double-materiality' is needed.

Directive 2014/95/EU, the existing EU guidelines on climate-related disclosures published in 2014, was reinforced in 2019 with supplementary 'non-binding guidelines' on reporting climate-related information: *Guidelines on non-financial reporting: Supplement on reporting climate-related information* (the Guidelines).[73] The Guidelines state '[i]t is very important for stakeholders to understand the company's view of how climate change impacts its business model and strategy, and how its activities can affect the climate, over the short, medium and long term'.[74] See Figure 22 for an illustration of a double-materiality perspective.

Figure 22: The double-materiality perspective

Source: European Commission, Figure 1, *Communication from the Commission — Guidelines on non-financial reporting: Supplement on reporting climate-related information*[75]



3.11 The International Sustainability Standards Board (ISSB)

Finding 1: ISSB is currently working on sustainability-related disclosure standards.

With the increasing prominence of ESG reporting being incorporated by issuers worldwide, investors with international portfolios require comparable, high quality and transparent information, regardless of a company's location. In order to meet this requirement, the International Sustainability Standards Board (ISSB) was formed by the International Financial Reporting Standards Foundation (IFRS) in November 2021. The ISSB implies a focus on disclosures that are material to investors by stating its purpose is to 'deliver a comprehensive global baseline of sustainability-related disclosure standards that provide investors and other capital market participants with information about companies' sustainability-related risks and opportunities to help them make informed decisions'. [76]

The ISSB has already begun making its contributions to the myriad of accounting standards. Two Exposure Drafts were published in March this year: (i) *Exposure Draft Proposed IFRS S1 General Requirements* for *Disclosure of Sustainability-related Financial Information* and (ii) *Exposure Draft Proposed IFRS S2 Climate-related Disclosures*[77]

3.12 The Taskforce on Nature-related Financial Disclosures (TNFD)

Finding 1: Nature-Related Risk & Opportunity Management and Disclosure Framework is in development.

A report published by the World Economic Forum, in collaboration with PwC, notes that more than half of the world's total GDP, $44 trillion in value, is either moderately or highly dependent on nature. This involves sectors such as construction and agriculture (valued at $4 trillion and $2 trillion respectively), but also sectors such as travel and tourism, and retail, which although not drastically dependent on nature, still have 'hidden dependencies'. [78]

It is in response to this that the Taskforce on Nature-related Financial Disclosures (TNFD) was formed in June 2021.

> The Taskforce consists of 34 individual Taskforce Members representing financial institutions, corporates and market service providers with US$19.4trn in assets …To develop and deliver a risk management and disclosure framework for organisations to report and act on evolving nature-related risks, with the ultimate aim of supporting a shift in global financial flows away from nature-negative outcomes and toward nature-positive outcomes.[79]

In a similar way as the ISSB, the TNFD will work towards filling information gaps currently experienced by companies and financial institutions that limit their understanding of how nature impacts their immediate and long-term financial performance based on negative or positive impacts the organisations have on nature. With better information, these organisations can begin to consider nature-related risks and opportunities when undertaking strategic planning.

The TNFD plans to release version 1.0 of its *Nature-Related Risk & Opportunity Management and Disclosure Framework* in September 2023. The approach will be market-led with combined input from leading science and data institutions, allowing for a scientifically sound framework that remains practicable for both companies and financial institutions. Of note is the fact that the TNFD will not be creating a new standard, instead building on and integrating existing standards into the above framework. [80]

3.13 COP15 Business statement for mandatory assessment and disclosure

Finding 1: Mandatory disclosures on biodiversity is being discussed.

The 15th meeting of the Conference of the Parties (COP) to the UN Convention on Biological Diversity (CBD) is due to take place in December this year. This conference will mark the adoption of the post-2020 global biodiversity framework which aims to 'provide … a strategic vision and a global roadmap for the conservation, protection, restoration and sustainable management of biodiversity and ecosystems for the next decade'.[81]

In response to the proposed framework, released in July 2021, Business for Nature (a global coalition consisting of forward-thinking companies and conservation organisations) is urging the policy makers in charge of its development to strengthen the framework by adding more ambitious targets, mainly 'mandatory requirements for large and transnational businesses and financial institutions to assess and disclose their impacts and dependencies on biodiversity, by 2030'.[82]

These mandatory disclosures on biodiversity are viewed as an 'essential first step' in providing businesses and financial institutions with the political certainty needed to shift business models, and governments with the information needed to enforce such change towards both a 'nature-positive and net-zero future'.[83]

Endnotes

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13 Figures 5 and 6, discussed in *Working Paper 2022/14– Reviewing TCFD information in 2017–2021 reports of NZSX-listed companies*, pp. 18–19, contain information from the following report, in particular Chapter 11.

Full report
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Chapter 12
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