



AUCKLAND CENTRE FOR
FINANCIAL RESEARCH

New Zealand Corporate Governance Index

2016 financial year end

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Introduction to the New Zealand Corporate Governance Index

The New Zealand Corporate Governance Index (NZCGI) provides a way to compare the corporate governance of companies in the NZX 50.

Corporate governance from an academic view is the mechanism that aligns shareholder and management interests, the so called “agency problem.” The more that interests are aligned, the more confident an investor can be that management is working in a shareholder’s interest.

The Auckland Centre for Financial Research (ACFR) has taken a number of research-backed measures that are known to indicate good corporate governance and scored NZX 50 companies against them. The index will be released annually to allow benchmarking of companies against their peers and own performance over time. This provides investors with a tool to further enhance their investment decision-making process.

The Measures:

Companies are scored on 17 research-backed measures and the scores are used to create the index. These measures fall under four broad categories:

- Shareholder structure. Max score: 3
- Board of directors. Max score: 7
- Independence. Max score: 12
- Remuneration. Max score: 6

The maximum score attainable is 28. The higher the score, the better a company is able to align shareholder and management interests.

The data:

We score the top 50 companies in the NZX by market capitalisation as at 1 July 2016. We exclude banks, unit trusts, companies run by a management company and companies that report under a non-NZX corporate governance framework. We replace excluded companies with the next largest by market capitalisation. Data is taken from:

- 2016 annual reports
- Company websites
- MBIE Companies Office

Scoring method:

We use two methods to score companies:¹

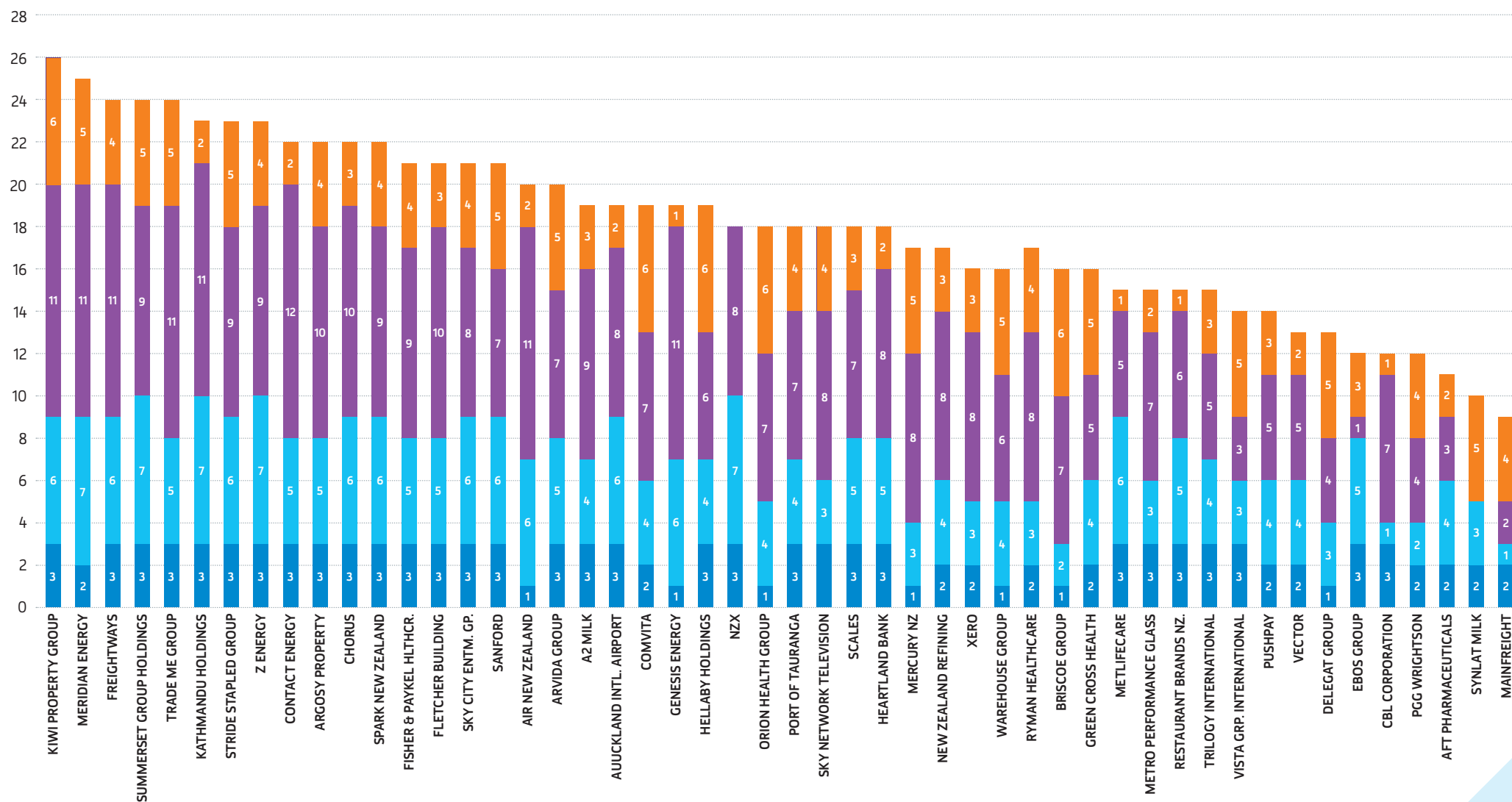
- Binary: A company scores a one if it passes a set threshold or a zero otherwise.
- Scaled: Multiple thresholds are set and a company can score up to a maximum score of three and a minimum score of zero.

¹ If a company does not report the information they are automatically scored a zero.

NZCGI Score

The following table shows the scores for NZX 50 companies for each dimension.
The maximum score a company can get is 28.

 **Shareholder structure** (out of 3)
 **Board** (out of 7)
 **Independence** (out of 12)
 **Remuneration** (out of 6)



Shareholder Structure

A company's ownership structure can determine how well shareholder's interests are represented in the company.

We use three measures to assess companies on their shareholder structure:

Measures:²

- **Institutional investor has over 5% shareholding:**
An institutional investor with a large shareholding has the resources and incentive to monitor management (and board) activities. Other shareholders who might not have the resources themselves to monitor benefit from the institutional investors actions.
- **No family/founder has over 5% shareholding:**
Family/founders with a large shareholding may treat the company's output/assets as their own and draw resources away from other shareholders.
- **No government has over 5% shareholding:**
A government has many stakeholders to think about and therefore may not make decisions in the best interests of other shareholders.

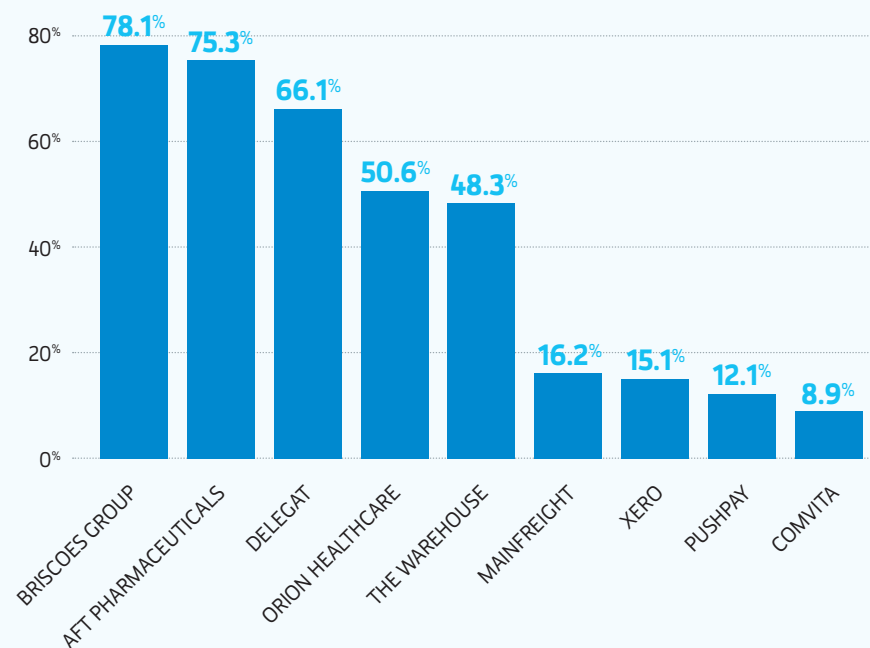
Scoring:

Scoring: true=1, false=0

Results:

Thirty six of our 50 NZX companies passed our institutional investor measure indicating large involvement from institutional investors in NZX 50 companies. All real estate, financials and telecommunications industries had large institutional investor shareholders, utilities companies had the lowest involvement. Forty one companies passed our family/founder measure indicating nine companies still had large involvement from their creators. Only three companies had government involvement in their shareholder structure: Air New Zealand, Genesis Energy and Mercury NZ.

Companies that have a family/founder large shareholding



² The threshold of 5% is used as under the FMC Act 2013, section 274 companies must disclose substantial product holders, the threshold being 5%.

Board of Directors

The board of directors is tasked with monitoring management on behalf of shareholders in order to align interests. The make-up and efficiency of the board can affect how well the board performs in its duties to monitor management. We use six measures to score companies.

Measures:³

- **Percentage of female directors:** A diverse board improves the monitoring function of the board. Research shows a higher percentage of female board members is linked to directors attending more meetings, allocating more effort to monitoring management and CEO pay having a better link to firm performance.
- **Average tenure of board less than nine years:** A board that has a long average tenure is less likely to exercise independence and monitor management effectively due to relationships built over time with management and the company. Experience with the company is required but spending an extended amount of time on a board is detrimental to the independence of directors. Nine years represents the 75th percentile of average tenure of directors in the S&P 500.
- **Average frequency of board meetings between 8 and 12 a year:** Research has shown there is an optimal number of board meetings. Too few board meetings means there is insufficient time for boards to monitor management effectively and perform their duties. Too many suggests an inefficient use of time by directors and a reduced ability to perform effectively.
- **Average attendance at board meetings is 90% or over:** As directors meet a few times during the year, a high attendance at board meetings is essential to ensure all issues are communicated and resolved.
- **Average attendance at committee meetings is 90% or over:** Committees are designed to address specific and important areas of a company with high efficiency. Committee meetings are also held very infrequently. Like board meetings, a high attendance is crucial to ensure issues are identified and remedied to the benefit of shareholders.

- **Audit committee has at least one qualified accountant:** A key source of information for investors are the financial statements of a company. These statements must be checked and monitored closely. A qualified accountant has the skills to ensure this takes place and gives confidence to shareholders of their ability to do so through a recognised qualification, rather than just 'financial experience.'

Scoring:

Female directors: 0%–15%=0, 16%–30%=1, over 30%=2

All others: true=1, false=0

Results:

Measure	Pass Rate	Average	High	Low
Female directors	–	22.6%	60.0%	0.0%
Average tenure	44	6.0	18.0	1.3
Average frequency of board meetings	27	10.4	16.0	6.0
Average attendance – board	36	95.7%	100.0%	82.1%
Average attendance – committee	33	96.2%	100.0%	84.2%
Qualified accountant on audit	40	–	–	–

*Pass rate shows the number of companies that fulfilled the criteria for a measure scored on a binary scale. Measures scored by scale do not have a pass rate.

In addition to the results 10 boards had no female directors, eight companies did not report the number of board meetings while 11 companies did not report attendance at board meetings and 14 did not report attendance at committee meetings. The lack of reporting on board and committee meetings is disappointing as this is useful information (and easy to report).

³ If number and frequency of board/committee meetings are not reported a company is scored zero.

Independence

To ensure shareholder and management interests are aligned a board must monitor management effectively. To do this the board must have independence from management and the company. The auditor must also have independence from the company to ensure a true and fair representation of the company through the financial accounts. We use six measures to score companies.

Measures:⁴

- **Number of independent directors:** The board is supposed to monitor management and therefore be independent. Having independent directors on the board is important to maintain the board's role and objectivity.
- **Average busyness of independent directors:** Independent directors enhance the monitoring role of the board over management. However, if independent directors have multiple board appointments (listed companies) they may not be able to devote enough time to each board.
- **Independent directors only on audit committee:** The board is responsible for ensuring a company's financial statements are correct and representative of the company. The best way to achieve this is to have an audit committee composed solely of independent directors.
- **Nomination committee over 75% independent directors:** As the job of the nomination committee is to hire and fire new directors and CEOs, a high level of independence is required.
- **Independent directors only on remuneration committee:** The pay of the CEO is an important part of aligning shareholder and management interests. In order for there to be no conflicts of interest this decision must be made by those who have no affiliation with the company – independent directors.
- **Ratio of non-audit to audit fees:** A high ratio of non-audit to audit fees increases the risk of the audit company losing their independence from the firm they are auditing.

Scoring:

Independent directors: 0-50%=0, 51%-65%=1, 66%-80%=2, over 80%=3

Average busyness: More than 3 directorships=0, between 2.25 and 3=1, between 1.5 and less than 2.25=2, less than 1.5=3

Ratio of non-audit to audit fees: over 60%=0, 46%-60%=1, 31%-45%=2, less than 30%=3

All others: true=1, false=0

Results:

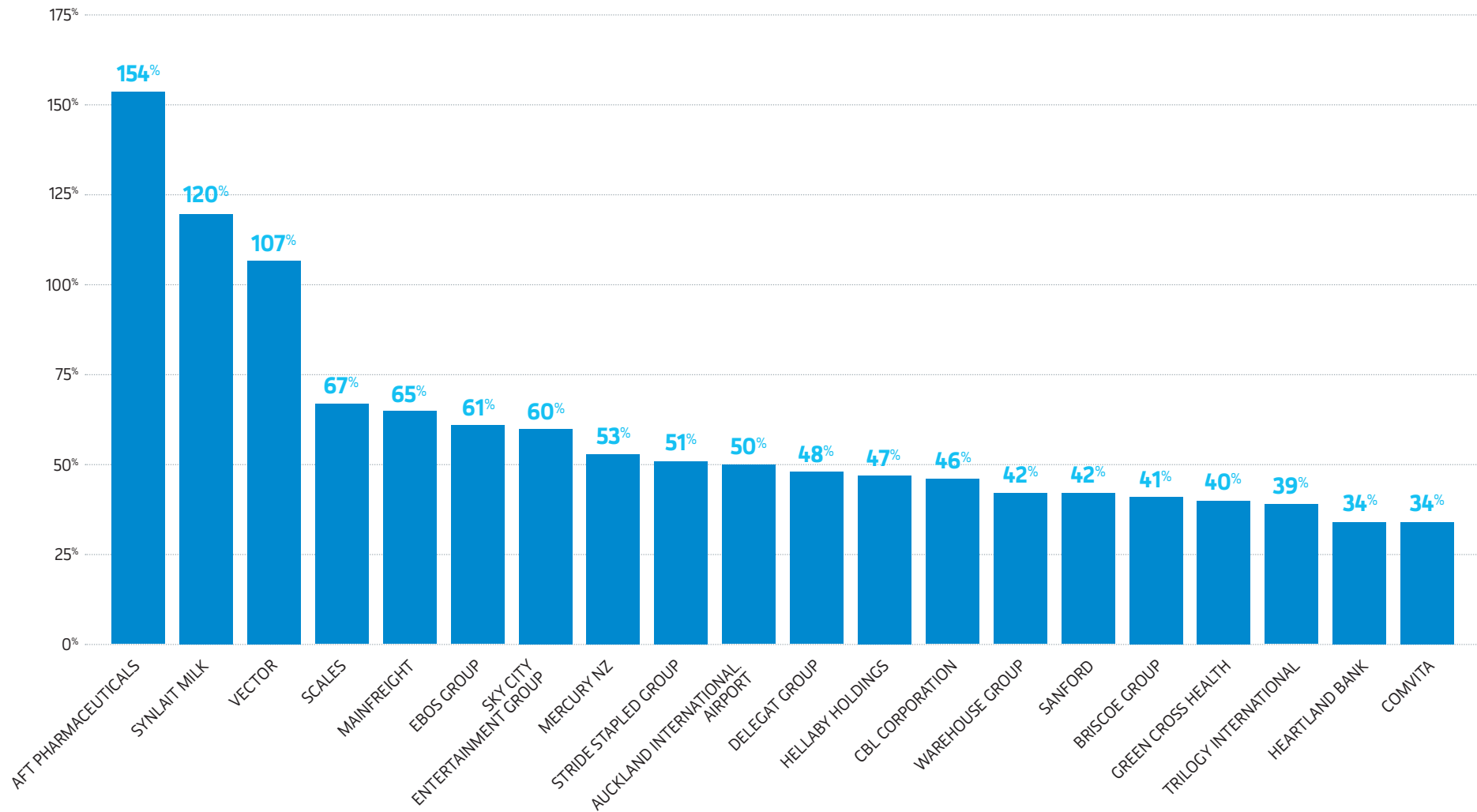
Measure	Pass Rate	Average	High	Low
Independent directors	-	73.8%	100.0%	33.3%
Busyness of independent directors	-	2.0	4.0	1.0
Independent directors only on audit committee	29	-	-	-
Nomination committee over 75% independent directors	24	-	-	-
Independent directors only on remuneration committee	21	-	-	-
Ratio of non-audit to audit fees	-	34.0%	153.7%	0.0%

*Pass rate shows the number of companies that fulfilled the criteria for a measure scored on a binary scale. Measures scored by scale do not have a pass rate.

- 12 companies had all independent boards and 10 had 50% or below independent directors.
- When non-listed companies are included, average busyness rises to 10.6 directorships, with the largest at 24 directorships per director.
- 11 companies did not have a nomination committee, four did not have a remuneration committee.

⁴ If a company does not have a nomination or remuneration committee it is assumed all directors take part in decisions.

Top 20 companies with largest non-audit to audit fee ratios



Remuneration

Remuneration of the CEO and management are a key mechanism used by the board to align the interests of managers with shareholders. Investors are limited by the information provided by companies through their annual reports. Many do not disclose pay or the composition or benchmarking of how a CEO is paid let alone top executives. We measure CEO remuneration using the information provided by companies through their annual reports.

Measures:⁵

- **Ratio of highest executive to CEO pay:** Research has found the greater the disparity between CEO and executive pay the more entrenched a CEO is. This makes replacement of the CEO harder for the board. An entrenched CEO also increases succession risk, especially when related to internal candidates.
- **Increase in CEO pay excessive:** The larger the increase in CEO pay year-on-year, the greater the likelihood the board is thinking about short-term performance rather than long-term increased shareholder value.

Scoring:

Executive pay to CEO pay: less than 25%=0, 25%-50%=1, 51%-75%=2, over 75%=3

Increase in CEO pay: over 30%=0, 21%-30%=1, 10%-20%=2, less than 10%=3

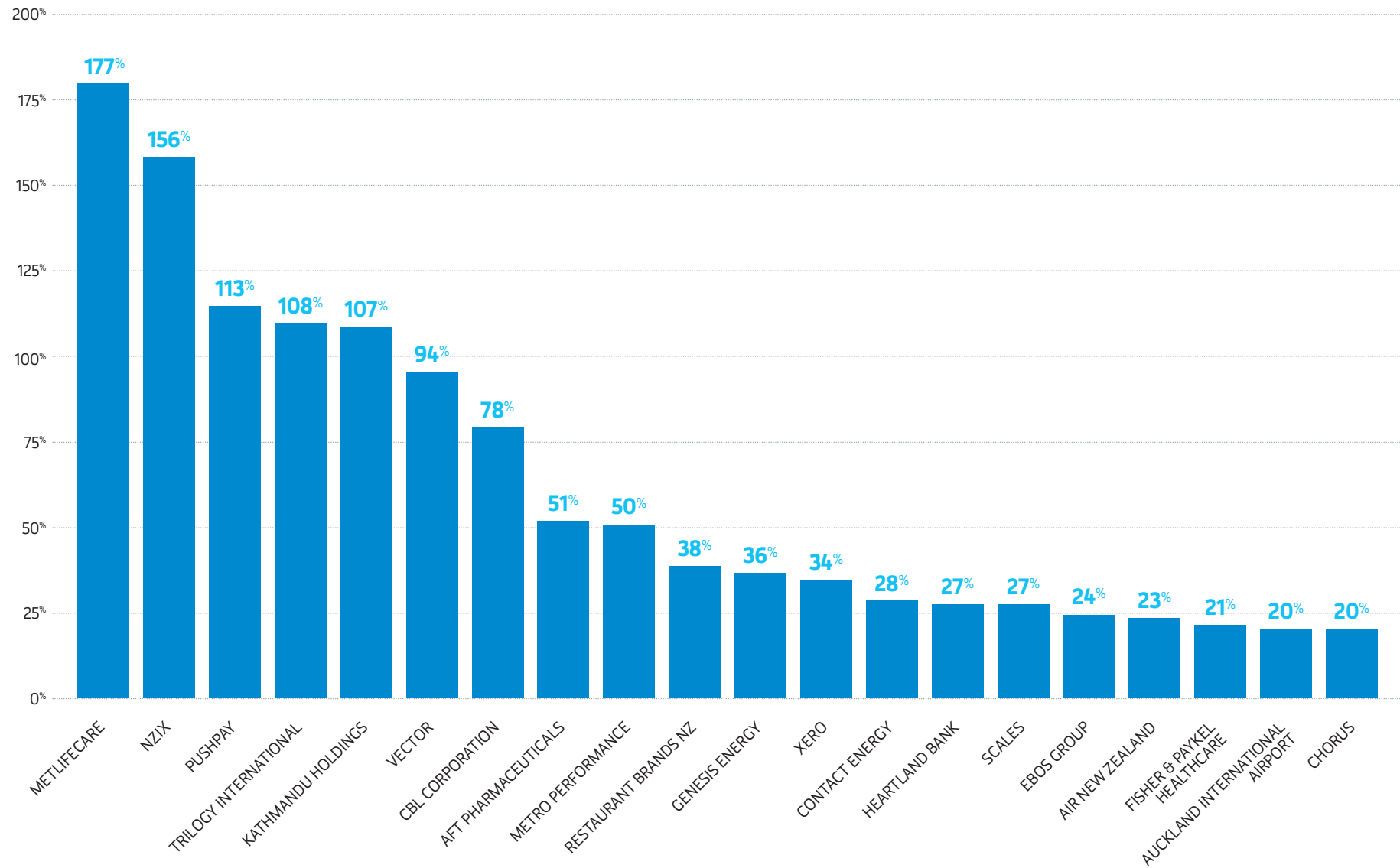
Results:

Measure	Average	High	Low
Highest executive to CEO pay	60.8%	218.1%	14.3%
Increase in CEO pay	26.1%	177.0%	-16.5%

- Average CEO pay in NZX companies was \$1.57 million. The highest pay was \$4.72 million (Fletcher Building), the lowest was \$0.38 million (Pushpay).
- Highest executive pay was \$2.2 million (Air New Zealand), the lowest was \$0.28 million (AFT Pharmaceuticals).
- The highest increase in pay was Metlifecare at 177%, the lowest increase was Orion Health Group -16%.
- 19 companies gave a breakdown of CEO pay and five gave a full disclosure of how CEO performance was calculated.

⁵ If CEO pay is not listed explicitly we use the highest pay bracket in a company's remuneration table, we use the second highest bracket for highest executive pay.

Top 20 companies with largest CEO pay increases



About the Auckland Centre for Financial Research

The Auckland Centre for Financial Research (ACFR) strives to achieve excellence in empirical finance and applied financial econometric research. We aim to do this by nurturing and developing world-class researchers, establishing relationships with leading academics and centres/ institutes in the field, developing research capacity of postgraduate and PhD students, and engaging with industry.

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