publications

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Directors' Duties and Responsibilities

Changes as the new Companies Act takes effect

Introduction

The trend to make directors personally accountable for a wider range of matters and to make them liable to heavier penalties has been recognised in the new Companies Act.

The 1955 Companies Act did not clearly articulate what the directors duties were. This resulted in a whole host of court cases that attempted to describe what the directors duties were. Any persor who became a director of a company prior to the 1993 Companies Act had to glean their responsibilities from these court decisions.

The problem with this approach was that in many instances the court decisions were seen in terms of specific issues that were addressed by the court and thus became very difficult to extrapolate to general duties. What was needed was a set of duties that were clearly promulgatec in the new Companies Act.

In addition to common law duties, the Companies Act 1955 contained some statements which where negatively expressed and which imposed liabilities on directors to creditors and minority shareholders in cases of reckless trading and minority oppression.

In determining what the directors' duties were, it was noted that it was probably more helpful for directors who wished to know what their responsibilities were, to have these obligations expressed positively as statements of general duty - and this was accomplished in the new act.

The 1993 Act now comprehensively restates the duties of directors and expands on them in important respects.

This article addresses two broad areas of directors' duties, namely:

- Duties in respect of shareholders
- General duties to the company

Duties in respect of shareholders

The 1993 Act recognises a number of powers exercised by directors where shareholder interest is particularly at risk. These are new and they override the decision in *Percival v Wright* by recognising that directors have direct duties to shareholders in circumstances in which they deal in shares on the basis of confidential information.

Directors have responsibilities, inter alia, in relation to:

- issue of shares
- registration of transfer of shares
- make distributions to shareholders
- repurchase the company's shares
- assist in the financing for acquisition of the company's shares
- redemption of shares

These are areas where the interests of the shareholders may be at variance with the interests of the company. Shareholder interest needs special protection because the management powers impinge upon the exercise of the residual proprietary rights of the shareholders and their constitutional position within the company.

The 1993 Act imposes particular duties upon directors exercising these powers, to protect the shareholders affected. Significant examples are the requirement in s47(2)(d) that before the issue of shares the board must resolve that the consideration and terms are fair and reasonable to the company and existing shareholders, and the provision in s45 that shareholders have pre-emptive rights which may only be varied by the constitution.

General Duties

The 1993 Act imposes general duties in relation to all actions of directors. These restate the common law basic duties of good faith and care and also clarify and reform the general duties of directors in relation to company confidential information, dealing in company shares, and transactions in which they have an interest.

These are discussed in more detail in the following paragraphs.

Fiduciary Duty - S131

A director occupies a fiduciary duty in relation to the company and has a fiduciary obligation, primarily the duty to act bona fide in the interests of the company. Directors must not accordingly place themselves in a position of a conflict of interest. The courts have always noted that directors occupy a position of trust and accordingly should not place themselves in a position where the interests of the company conflict either with their own interests or those of any person with whom they are associated.

Courts have always insisted that directors exercise their power in good faith, in the best interests of the company and for the purpose for which they were conferred.

Good faith is an equitable concept which requires more than 'honesty'. Dishonesty is a matter for the general criminal law, which is why the 1993 Act does not back up director duties by criminal sanction.

Directors must act in good faith and in what they believe to be the best interests of the company.

This is a subjective test in the mind of directors, ie. as they perceive it.

Proper Purpose

Directors must exercise their power for a proper purpose. The concept of proper purpose was originally derived from the case law on power. Each case must be judged on the facts - a subjective duty. The courts will examine the purpose for which the power was granted and determine the limits within which the power could be exercised.

This duty is not concerned with good faith. For example, a director may act bona fide, believing such action is in the best interest of the company but exercise the power for an improper purpose.

There is a lack of guidelines against which the power could be assessed. However, recent cases seem to use ‘proper purpose’ to impose an objective standard where good faith of directors is accepted.

Duty to comply with Act and Constitution

A director must act in a manner that does not contravene the Companies Act 1993 or the constitution of the company. Although only the Companies Act is mentioned, failure to comply with any other Act would result in directors acting for an improper purpose which is unlikely to be in the best interests of the company.

The Act imposes numerous statutory responsibilities upon directors and failure to comply would result in penalties being imposed.

Reckless Trading

This duty refers to the obligation on directors to carry on the operations of their company in a manner that is unlikely to create a substantial risk of serious loss to the creditors.

Reckless trading to which directors are parties was previously covered by s320(1)(b) of the Companies Act 1955, which applied only on liquidation. However, s135 of the 1993 Companies Act applies from the inception of the company. Further differences are noted below:

- s320(1)(b) referred to the carrying on of any business of the company, and it was held that this could refer to an isolated transaction even if it was not one arising in the course of carrying on the company’s usual business.
- s135 refers to the carrying on of the business of the company, and this may imply that isolated transactions do not fall within its terms.

Both the old and new provisions centre upon the concept of recklessness.

Duty to act with care

At common law a director’s duty of care and skill was unduly restricted in favour of directors. The leading case is City Equitable where proceedings for breach of duty were brought by the liquidator of a failed insurance company against the directors and auditors.

S137 sets out the standard of care required of directors. It is an attempt to overcome deficiencies in the common law by imposing duties of care, diligence and skill. These duties are to be measured against what can reasonably be expected of a director acting in like circumstances.

It is reasonable to expect a certain level of competence of directors although the level of competence will vary markedly according to the nature of the company.

The Act does not impose a higher standard of skill on directors who hold relevant professional qualifications, and in that respect also departs from the common law position established in the

City Equitable case. Where a director has special skills, the courts will expect the director to exercise those special skills. This creates a dual standard of care. One standard will be appropriate for directors who have no specialist skills and another for specialist directors like lawyers or accountants.

The courts have held that a director who acts honestly, could only be liable in damages if guilty of gross or culpable negligence in the business sense. Broadly this meant something less than a duty to take all possible care. Directors should act with the ordinary degree of prudence which a person would demonstrate in managing their own affairs.

The courts have interpreted that a director's duty of care and skill was qualified by the standard of gross or culpable negligence. This remained the yardstick until the coming into effect of the Companies Act 1993.

A director, when exercising powers or performing duties as a director, must exercise the care, diligence and skill that a reasonable director would exercise in the same circumstances.

In judging each case, care, diligence and skill which a reasonable director would show in the following factors must be taken into account:

- the nature of the company;
- the nature of the decision; and
- the position of the director and the nature of the responsibilities undertaken by the director.

The standard is now one of the reasonably competent director. But the Act recognises that circumstances differ widely from company to company.

Duty in relation to obligations

A director must not agree to the company incurring an obligation unless the director believes that the company will be able to perform that obligation when required.

In the course of restating the liability of directors for reckless trading as part of their general duties during a company's life, s320 of the 1955 Companies Act went too far towards inhibiting the use of the company form as the vehicle for the taking of business risk.

S135 of the 1993 Act imposes personal liability only where the directors have 'unreasonably' risked insolvency. A director must not agree, or cause or allow, that the business of the company be carried on in a manner likely to create a substantial risk of serious loss to the company's creditors.

S135 describes a minimum standard. After that standard has been met, the directors may take into account the interests of creditors in exercising their functions so long as it is consistent with their fundamental duty to the company and to shareholders' interests.

Duties in relation to third parties

While a director's duties are largely owed to the company, the interests of third parties must be taken into account.

Creditors

The courts have noted that directors are obliged to consider the interests of creditors in situations of insolvency or near insolvency.

The duty of directors to creditors has been met by the structure of the Companies Act 1993. Key to the protection of creditors are the rules relating to distributions to shareholders.

In addition, while a director's duties are primarily to the company, a creditor of a company in liquidation may apply to the Court under s301 for a director who has misapplied, retained, or become liable for, money or property of the company, or been guilty of negligence, default or breach of duty or trust, to transfer money or property to the company or to the creditor.

Maintain company information in confidence

The 1955 Companies Act provisions relating to company confidential information was unclear and was silent in its application to nominee directors and their nominating shareholders. The law relating to directors dealing in shares was plagued by ambiguities as to the circumstances in which the directors owe duties directly to shareholders.

Directors frequently acquire information not generally known to the public such as profit forecasts proposed share issues, borrowings, reconstructions, trade secrets. This information is the property of the company and it would be improper to disclose it or allow it to be disclosed to any person unless the disclosure has first been authorised.

Directors are now under a duty to maintain company information in confidence, and in particular are obligated to disclose transactions in which they have an interest.

Directors who use company information without paying adequate value to the company are liable to the company for any loss suffered.

Summary

No organisation can enjoy a good reputation unless it is considered trustworthy. Trust and a reputation for reliability rest primarily on the discharge by the directors of their fiduciary duties.

If there is no confidence that an organisation's directors are behaving in the interests of the organisation as a whole, if they are thought to be benefiting themselves unfairly at the expense of the members, the company's reputation, the basis of their accountability and ultimately public confidence in the 1993 Companies Act would be undermined.

In this regard, there have been some fundamental changes to the 1955 Companies Act which have been incorporated into the 1993 Companies Act. Directors will need to have a thorough understanding of these duties or face the prospect of stiff penalties or personal liability.

Corporate Governance

Objectives

Corporate governance is the system whereby corporations (public and private) are directed and controlled. It therefore follows that good corporate governance involves establishing systems of structuring, operating and controlling a corporation so as to achieve:

- good management
- good relations with all stakeholders (shareholders, staff, trading partners etc)
- good behaviour regarding the environment
- good compliance with legal and regulatory requirements.

A new age of greater transparency and accountability

Opinions differ as to why the topic has become one of the leading business topics of the 1990s. However, the global recession and some spectacular financial crashes and asset write downs (such as Polly Peck, BCCI and the Maxwell empire in the UK) have focused attention on concerns over the effectiveness of boards of directors especially as regards their accountability in the light of increased white collar crime. Concerns were also expressed regarding the relevance and adequacy of financial reporting and the effectiveness and value of external audits.

In this age of greater transparency and accountability the expectations of stakeholders are growing. Proper disclosure and fair reporting have replaced statutory compliance with minimal explanations and disclosures.

Developments abroad

Corporate governance guidelines have been developed in the following western countries:

United Kingdom - The Cadbury Report
United States of America - COSO - Treadway Commission
Canada - Toronto Stock Exchange Commission
South Africa - King Report
Australia - Australian Stock Exchange

Although the content and requirements of each regulatory body vary, the common theme is for greater transparency, appropriate and responsible reporting and greater emphasis on the duties of directors.

The need to forge ahead

International investors, in particular, require evidence in financial reports of good corporate governance. Any deficiencies in this process could have serious consequences for your corporation.

Currently in New Zealand there is no regulatory responsibility to report on corporate governance. However disclosure in Australia is mandatory for corporations listed on the Australian Stock Exchange and the likelihood must exist that New Zealand will follow the rest of the world. In any event good corporate governance is a market differentiator and we encourage our clients to be ahead of the pack and to be prepared for the arrival in New Zealand of the new regime.

Services offered by Deloitte Touche Tohmatsu

The corporate governance service line based in Wellington with Ian Marshall and Ric Andrews can give advice and assist clients in converting corporate governance into a value added product. The range of services offered include:

- High level corporate governance reviews and advice
- Internal control reviews and consulting
- Internal audit management and administration
- Performing internal audit work or co-sourcing of internal audit work

The benefit of the service line is that it is a value added product where clients determine the scope and deliverables according to their needs.

Deferred Tax - Quo Vadis?

A revised accounting standard on taxation has been issued by the International Accounting Standards Committee. IAS-12 (revised): *Income Taxes* is likely to cause a stir amongst standard setters and reporting entities alike. Radical changes include:

- **The end of the partial basis.** The comprehensive basis is mandatory in the new IAS-12. New Zealand reporting entities which at present account for deferred tax on the partial basis will probably be allowed to make the retrospective adjustment against opening equity in the *statement of movements in equity.* However, the honeymoon will have ended, and future surpluses of such entities are likely to be significantly reduced as a result of the additional tax charge.

  The advantages are:

  - an improvement in comparability between reporting entities; and
  - less scope for manipulation of results.

- **Temporary differences will replace timing differences**

  - *The old timing differences* described the adjustment to tax expense to allow for matching of tax expense against surplus before tax, by the use of the *deferred tax* mechanism to bridge the gap between the recognition of revenues and expenses in the *statement of financial performance* and the recognition of those financial elements by Inland Revenue.

  - *The new temporary differences* result in the measurement of deferred tax by comparing the values of assets and liabilities in the *statement of financial position* with the tax values (or 'tax bases', as described by the IASC).

  This is called 'the balance sheet approach'. The concern with the theoretical description of this approach in IAS-12 (revised) is that some 'balance sheet' items, such as goodwill, have zero tax bases, and nonsensically give rise to deferred tax. The standard therefore has to provide for some exceptions to the general rule.

  In essence the new standard widens the scope of deferred tax to include the tax effect of changes in net asset values other than those recognised in the *statement of financial performance.* The two components of *temporary difference* deferred tax are:

  (a) timing differences arising in the *statement of financial performance* (income - based deferred taxation);
  (b) differences arising from surpluses (deficits) which are credited directly to equity, to the extent to which those surpluses (deficits) would be taxed if realised (reserve-based deferred taxation). For example, that part of any amount credited to an asset revaluation reserve which would be subject to depreciation recoupment tax should the asset be sold will give rise to reserve-based deferred tax on the potentially taxable revenue portion of the revaluation reserve.

  Whereas income-based deferred tax is an adjustment to tax expense, reserve-based deferred tax movements are debited or credited directly to the relative reserve.

  Our own SSAP-12 (paragraphs 4.29 and 4.30) already requires deferred tax to be recognised directly against the reserve on the partial basis. The deferred income tax effect of a timing difference arising on the revaluation of an asset "should be recognised directly against the revaluation reserve if the income tax effect is expected to crystallise through the realisation by sale of the asset in the foreseeable future". The effect of adopting the IAS-12 requirements will be the recognition of such deferred tax on the comprehensive basis.

- **A deferred tax asset, will be recognised if it is probable that future taxable profit will be available against which the temporary differences or unused tax losses can be utilised.** Our SSAP-12 allows the recognition of a tax asset only if there is virtual certainty of recovery in future periods. Adoption of the IAS-12 ‘probability’ requirement will bring our standard into line with our *Statement of Concepts for General Purpose Financial Reporting.*

- **IAS-12 (revised) eradicates any idea one might have of discounting the deferred tax balance.** It stipulates that deferred tax assets and liabilities shall not be discounted.

Accounting for EDP Year 2000 costs

This issue concerns determining the most appropriate accounting treatment of the costs associated with converting computer software for application after the ‘Year 2000’ and in particular:

- whether such costs should be treated as an expense or capitalised; and
- when such costs should be recognised.

There are three possible scenarios for those whose computer programmes cannot cope with the year 2000:

1. It has been decided to modify the computer software to ensure one’s computer systems can process the year 2000 dates.

These costs should be recognised as an expense when incurred. This is in line with decisions of the Urgent Issue groups of UK, USA and Australia.

2. It has been decided to replace the computer system completely or in part.

That portion of the system which is to be replaced must be depreciated to zero by the date of replacement. The cost of the replacement may then be recognised as an asset. It would be good disclosure for clients whose computer systems are susceptible to the Year 2000 problem to disclose this fact in the annual report as well as the extent of the problem and action plans.

Financial Reporting Standard 24 (FRS-24)

Interim Financial Statements

Interim financial statements for periods beginning on or after 1 July 1997 should be prepared in accordance with FRS 24 approved by the ASRB on 12 December 1996. The new standard is applicable to interim financial statements of all entities except where the financial statements are included in a registered prospectus or the interim financial information is expressed solely in general terms such as monthly statements produced by unit trusts.

The significant aspects of the revised standard are:

- the incorporation of differential reporting exemptions for qualifying entities,
- the retention of the discrete method which was required by SSAP-24 and the provision of some additional guidance on the application of this method,
- clarification and extension of the minimum disclosure requirements,
- the requirement that the measurement and recognition principles contained in financial reporting standards are to be applied to the interim period except that non-current assets such as investment property are not required to be revalued and where assets are revalued directors valuations are permitted (the basis of valuations must be disclosed),
- the removal of the requirement to disclose whether the interim financial statements have been audited.

The Discrete Method

The standard requires that the interim period be treated as a discrete financial period to ensure that the results for the interim period reflect the economic activity of that period rather than outcomes based on assumptions about operations pertaining to the unexpired portion of the annual reporting period.

It is interesting to note that our standard setters differ in opinion to their UK counterparts in their treatment of taxation under this method. The discrete method under FRS-24 requires tax to be accrued in accordance with SSAP-12 for the interim period. Entities in New Zealand are not permitted to estimate the effective tax rate for the year and apply this to the interim period whereas the UK exposure draft on interim reporting requires the governing body to do so.

Disclosure requirements

Some additional disclosures are required by FRS-24, notably:

- a statement of movements in equity
- minority interests in extraordinary items
- the nature and amount of any recognised or unrecognised material items if this is necessary to explain the performance of the entity
- significant changes in the operational or financial circumstances or environment since the previous annual report (eg disposal or acquisition of a business segment)
- entities are required to consider whether there have been any major changes in unrecognised items since the previous annual report
- increased cash flow disclosures which must now include gross cash inflows and outflows from each of operating, investing and financing activities (SSAP-24 permitted net cash flows to be reported); a reconciliation of net operating cash flow to net surplus after taxation; cash balances at the beginning and end of the period and information on non-cash investing and financing activities,
- separate disclosure of certain items within current and non-current assets and liabilities such as receivables, payables, inventory, bank balances and intangibles
- subsequent events
- a statement that the financial statements are prepared under FRS-24 and should be read in conjunction with the previous annual report.

Differential reporting exemptions consistent with those permitted for full annual reporting apply in respect of these additional disclosure requirements. For example the differential reporting exemption which applies to cash flow statements per FRS-10 for annual reporting also apply to FRS-24. Where a qualifying entity chooses to take advantage of differential reporting exemptions allowed this must be disclosed.

In summary FRS-24 is not a radical change from its predecessor SSAP-24 but has sought to clarify concepts, improve the reporting consistency between annual and interim financial reports, provide more informative disclosures and incorporate the differential reporting framework.

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