

Legal Opinion 2020/01

Obligations on directors to report risk in New Zealand annual reports under the Companies Act 1993

About McGuinness Institute

The McGuinness Institute is a non-partisan think tank doing the research others are not. We are committed to positively influencing public policy by empowering New Zealanders to have the uncomfortable, but necessary, conversations that are required to enable New Zealand to realise its potential as a country.

Legal opinion: Obligations on directors to report risk in New Zealand annual reports under the Companies Act 1993 was commissioned to describe in general terms the framework for annual reporting by companies and directors under the New Zealand Companies Act 1993, and in particular the extent to which the Companies Act 1993 requires disclosure of risks (such as climate or pandemic).

It is intended to be read alongside the McGuinness Institute's *Working Paper 2020/02 – The Role of a Directors' Report: An analysis of the legislative requirements of selected Commonwealth countries* and Project 2058 Report 17: *Building a reporting framework fit for purpose*.

About Gerald Fitzgerald

Gerald is the Founder of Fitzgerald Strategic Legal. He has more than 35 years legal experience primarily in financial services, corporate law and governance. Formerly with one of New Zealand's large law firms (the last six as Chair) he established his present firm in 2018 to allow him to focus particularly on strategic issues of governance, corporate and family succession, and environment.

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27 May 2020

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Attention: Wendy McGuinness

By email

Companies Act 1993 – Annual Reporting Requirements

1 Introduction and summary

- 1.1 You have asked me to describe in general terms the framework for annual reporting by companies and directors under the New Zealand Companies Act 1993, and in particular the extent to which the Companies Act 1993 requires disclosure of risks (including, but not limited to, risks such as climate or pandemic).
- 1.2 You will see that whilst there is no specific requirement in the Companies Act for directors to report on risks (let alone specifically climate or pandemic-related risks), I can see arguments that a failure to include in annual reports disclosure concerning imminent and proximate risks could in some circumstances give rise to directors' liability to shareholders.
- 1.3 Your question has highlighted an uncertainty in our Companies Act that is probably best addressed by way of a legislative change to require the inclusion of key material risks within the mandated annual reporting framework for companies provided for by sections 208 and 211 (subject to the present 'opt in/opt out' regime).

2 Preliminary observations as to governance

- 2.1 In considering the reporting framework, it is helpful to bear in mind the fundamental principles of management and governance of companies in New Zealand.
- 2.2 Our Companies Act recognises that the business and affairs of a company are (and must be) managed by or under the direction of the company's board (section 128) – not shareholders.
- 2.3 The Act specifically requires directors (amongst other specific duties) to:
 - a act in the best interests of the company;
 - b act in a manner which is not likely to create a substantial risk of serious loss to the company's creditors (section 135); and

- c exercise the care, diligence, and skill that a reasonable director would exercise in the circumstances of the particular company and the relevant issue (section 137).
- 2.4 These duties overlay the specific reporting and other duties the Act requires of directors. Some duties set out in the Act are specifically expressed to be duties owed to the Company, and others to shareholders. In my view it follows logically from the vesting of governance responsibility in directors that the Act's reporting obligations are duties owed by directors to shareholders. This has implications for liability as I discuss below.
- 2.5 These reporting obligations (both financial and general) have been tailored to allow shareholders to 'opt in' or 'opt out' of many reporting requirements to suit the size and nature of the entity. This letter does not consider the permutations which arise from such choices and only addresses the default position. Nevertheless, the 'opt in/opt out' provisions provide an appropriate mechanism to balance the cost/benefit analysis from any legislative change.

3 Financial Reporting – sections 196 - 207ZB

- 3.1 The extent and manner of financial reporting is set out in sections 196 – 207ZB of the Act.
- 3.2 Broadly these provisions require preparation of financial statements by companies in accordance with applicable financial reporting standards appropriate to the size and nature of the company and the wishes of its shareholders.
- 3.3 These financial statements must be:
 - a Signed on behalf of the company by its directors (section 201); and
 - b Included in the annual report sent to shareholders (section 211(1)(b)).
- 3.4 None of these financial reporting sections in the Act specifically address a requirement to report on risks generally or financial risks arising from events such as pandemics or climate change. That is left to the standards.
- 3.5 I note there is the general reporting requirement in paragraph 125 of NZIAS1:

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.
- 3.6 But it is interesting to observe the relatively narrow scope of this standard – 'carrying values of assets and liabilities' and 'the next financial year'.
- 3.7 Likewise, I am aware of specific requirements in respect of the risk of certain financial instruments.
- 3.8 It is not clear to me that any of these standards requires a more general disclosure of the risks with which you are concerned.
- 3.9 It would, of course, be open for financial reporting standards to require such reporting, and thereby become an obligation under the Financial Reporting Act, and

consequently, the Companies Act in respect of those companies to which the standards applied.

4 Section 208 – general reporting obligation

4.1 Section 208 is the starting point for a consideration of the extent of the board's more general reporting obligations. It forms part of the Act (Part 12) which is entitled '*Disclosure by Companies*' and appears immediately below a heading '*Disclosure to Shareholders*'.

4.2 Section 208 is titled '*Obligation to prepare annual report*'. It applies to all companies subject to the 'opt in/opt' out provisions in 208(1)(d) & (e) (which I have previously noted I do not address).

4.3 Section 208(2) requires the board of every company to which the section applies to prepare an annual report:

'on the affairs of the company during the reporting period.'

Note: this obligation requires directors to report on the '*affairs*' of the company. It is separate from the financial reporting obligations which are set out in the immediately preceding part of the Companies Act. I think it is therefore reasonable to infer that this section contemplates a narrative from the board which provides insight into the company's activities over the past reporting period separate from the financial data required by the financial reporting provisions.

4.4 The section is, however, very general in scope and, whilst subject to the requirements of section 211, it leaves it to the board to determine the extent to which the '*affairs*' of the Company are explained. In particular '*affairs*' seems capable of a broader meaning than a mere listing of the day to day '*activities*' of a company.

4.5 By way of example, it would seem odd if a company operating a tourism business, in preparing its annual report in today's environment, would not include commentary on the historical and forward impact of the closure of businesses and borders as a consequence of the pandemic and declaration of a national state of emergency.

4.6 In contrast to the general requirement of section 208 to report on the '*affairs of the company*', Section 211(1) is specific and prescriptive. It prescribes the particular content and requirements of the annual report (again subject to the opt out provisions of 211(3)). In my view, however, section 211 is to be read alongside 208 and does not read down the general obligation to report '*on the affairs of the Company*'. Section 211 is simply prescriptive of certain minimum disclosures and does not displace the more general obligation in section 208, particularly if the minimum were to leave a shareholder with a misleading understanding of the affairs of the company.

4.7 Section 211(1)(a) requires the annual report to describe changes in:

a '*the nature of the business of the company*'; or

b '*the classes of business in which the company has an interest.*'

but leaves to the discretion of the directors the ability to determine what changes are material, and what disclosure might be harmful to the business. The Act recognises

the desirability of a balance between informing shareholders and keeping commercially sensitive information confidential.

- 4.8 Importantly Section 211(1)(a) does not require disclosure or discussion of the business itself and its affairs. It certainly does not require the annual report to disclose perceived risks (present or imminent). Instead, section 211(1)(a) only requires disclosure of changes in the *'nature'* of the company's business, and I do not think that a risk readily falls within the concept of the *'nature of business'*.
- 4.9 While section 211(1) may not require the annual report to disclose risks, it may nevertheless be arguable that such disclosure is required by the more general obligation in section 208(2) to report on the *'affairs of the company'*.
- 4.10 I have read the opinion prepared by Chapman Tripp in October 2019. I note their opinion at paragraphs 93 - 94 that in certain circumstances disclosure of climate related risks may be required of entities to meet their financial reporting obligations.
- 4.11 I agree with that view. I think, however, that in some circumstances the disclosure of climate related risks (or indeed any risk which is sufficiently material, proximate and imminent so as to warrant active management by the board) could also be a matter which a Court might decide falls within the general obligation of section 208 to report on the *'affairs of the company in the preceding period.'*
- 4.12 While in the time available I have not had the opportunity to research whether the point has yet been tested, it is conceivable that liability might attach where a board fails to disclose a serious proximate and imminent risk in its annual report which is not apparent from other publicly available information and which subsequently eventuates and causes loss to shareholders.
- 4.13 This is because the very purpose of imposing a general reporting obligation on boards is to enable shareholders to understand businesses in which they have invested and to make informed decisions based on that disclosure (whether that be a voting decision, or a decision whether to sell, retain or increase an investment).
- 4.14 A specific requirement of section 211(k) is that the annual report be signed *'on behalf of the board'* by directors.¹ From this obligation; the overall framework of governance provided for by the Act, and the provisions of Part 12, I have little doubt that the obligation in section 208(2) to prepare an annual report is a duty owed by directors to shareholders, with the consequence that a breach of that duty renders directors vulnerable to actions by shareholders for a breach of that duty.
- 4.15 Is it too far a stretch to conclude that the scope of the directors' duty to shareholders under section 208(2) extends to ensure that annual reports fairly and adequately address any proximate and imminent risk which could have a material impact on the financial performance of the business?

¹ It is convenient to note at this point that I believe the annual report required by our Companies Act is effectively what some other jurisdictions may call a 'directors' report'. Likewise, while some documents published in New Zealand may contain a section titled 'Directors' Report' and other sections titled 'Chief Executive's' or 'Management Report', in my view, when published as a single document, the whole document is the annual report and that directors accordingly have responsibility for its content.

- 4.16 While this may not have been contemplated at the time the Act was drafted (30 years ago), it is clear that expectations of the business community for effective corporate governance and reporting have increased. The Act provides the scope for Court's to follow that change in sentiment.
- 4.17 Such a duty would fit comfortably with the obligation not to engage in misleading or deceptive conduct in relation to any dealing in financial products imposed by section 19 of the Financial Markets Conduct Act.
- 4.18 Likewise, it would fit comfortably with the obligation under the Financial Markets Conduct Regulations to disclose key risks when an entity raises money from the public. Afterall, it would be a slightly strange result if the obligation to disclose risks ended with the capital raising, when investor reliance on disclosure continues for ongoing decisions concerning the investment.
- 4.19 However, the present position is that neither sections 208 nor 211 specifically require such disclosure of risks. Absent a specific statutory requirement (or other obligation arising under (say) Listing Rules), and absent a court decision confirming the obligation exists in any event, it is unlikely that companies will voluntarily move to greater risk disclosure in their annual reports.
- 4.20 It would be better that legislation address the point, and my preference would be that section 211 be varied to include a more explicit requirement for annual reports to address proximate and imminent risks which would be reasonably likely to have a material adverse effect on the company's financial position or financial performance if they were to materialise.
- 4.21 The 'opt in/opt out' provisions of the Act provide an appropriate mechanism to balance the cost/benefit analysis from any legislative change and allow companies to choose their preferred approach.
- 4.22 Such legislative change might be best aligned with appropriate changes in financial reporting standards.

Yours faithfully



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