

**IN THE DISTRICT COURT  
AT AUCKLAND**

**CRI-2008-004-029199**

**MINISTRY OF ECONOMIC DEVELOPMENT**  
Informant

v

**JOHN MICHAEL FEENEY  
JOHN CARLAW HAGEN  
PETER DAVID HUNTER  
TIMOTHY ERNST CORBETT SAUNDERS  
PETER THOMAS**  
Defendants

Hearing: 12, 14-16, 21-23, 26-30 April, 28-30 June and 1 July 2010

Appearances: B Dickey and S Symon for the Informant  
A Galbraith QC, D Cooper and S East for the Defendants Saunders,  
Hunter and Hagen  
P Davison QC and R Woods for the Defendants Feeney and Thomas

Judgment: 2 August 2010

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**RESERVED DECISION OF JUDGE J M DOOGUE**

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## **INTRODUCTION AND SUMMARY OF CONCLUSIONS**

[1] The defendants (“directors”) were directors of Feltex Carpets Ltd (“Feltex”), a company listed on the New Zealand Stock Exchange (NZX). Each of the directors faces two charges under s 36A of the Financial Reporting Act 1993 (“FRA”). In short, it is alleged that a statement containing interim financial information for the half year ended 31 December 2005 failed to comply with applicable reporting standards required by the FRA and that the directors have failed to prove that they took all reasonable and proper steps to ensure that the applicable requirements of the FRA would be complied with.

[2] Feltex announced its half year results and issued the statement on 20 February 2006. The statement was approved by Feltex’s Audit and Risk Management Committee (“audit committee”) and recommended to the board for adoption at the audit committee’s meeting of 16 February 2006. The board approved the statement at its meeting on 19 February 2006.

[3] The directors all accept that the statement failed to comply with the applicable reporting standards. The issue I have to determine is whether the directors did or did not take all reasonable and proper steps to ensure that the applicable requirements of the FRA would be complied with.

[4] As at December 2005, New Zealand was in a transition period from its previous accounting standards (“GAAP”) to the adoption of the New Zealand equivalent of International Financial Reporting Standards (“NZIFRS”). Feltex chose to adopt NZIFRS as early as it could. Its 31 December 2005 interim financial statements were its first financial statements prepared under NZIFRS. Feltex was one of the first New Zealand companies to report under IFRS.

[5] Feltex’s directors knew that the new standards were complicated and voluminous and that they had to be worked through with an eye for the detail and any significant changes. They resolved it was necessary for the company’s credibility to position the company to be able successfully to effect the initial

transition to utilisation of IFRS and to secure their successful ongoing utilisation. So they set up comprehensive processes and procedures to ensure that these outcomes were attained. They took these steps not because they were seeking to protect themselves but in order to promote the interests of the company by ensuring compliance with the FRA in this new and challenging accounting standards environment.

[6] One of the charges relates to a failure of the financial statement to disclose breaches of which the directors were aware of certain financial covenants contained in an ANZ Bank facility agreement. The other concerns a failure to classify the ANZ liability as a current liability. Some readers of this judgment might think – if directors know there has been a breach of a financial covenant in a facility agreement, it follows that the breach should be disclosed in the financial statement; and if directors know that a breach of a financial covenant, or some other circumstances, permits the lender to call up the loan, it follows that it should be classified as a current liability. That is a logical view to take of matters at first blush. Somewhat surprisingly for the uninitiated, those were not the requirements under the previous accounting standards which favoured a substance over form approach – to be contrasted with the more prescriptive, form over substance, approach of the new standards. Under the substance over form approach of the previous standards which had prevailed during the professional lives of these directors up until this point, they were entitled to form a view based on expectations of what the lender would actually do, irrespective of the lender's strict legal rights. The evidence concerning the dealings between the company and the ANZ Bank demonstrated that during the material time Feltex's directors and management, and indeed their specialist accounting advisers Ernst & Young, were entitled to and did hold the view that ANZ would not be relying upon its strict legal rights and would be providing continuing support for the company. This state of affairs meant that the financial statement complied with the requirements of the previous standards. But it was insufficient to meet the requirements of the new standards.

[7] As will appear from the body of the judgment, the IFRS standards are highly complex and presume in-depth knowledge of accounting principles. Those applying them and advising in relation to them have usually undergone specialist training

because their interpretation and application requires highly specialised expertise within an already specialised field. Specialist auditors look to technical directors for assistance on their interpretation and application. These directors were entitled to seek and rely upon specialist advice. Ironically, it seems clear that the company's specialist advisers were themselves judging the financial statement by reference to the requirements of the previous standards rather than the requirements of the new standards. That is the single most important reason why the directors have ended up having to face this prosecution.

[8] Having considered the evidence, the legal principles applicable and the respective submissions of the Crown and Defence, I find each of the directors not guilty of the charges laid. I find that they did take all reasonable and proper steps to ensure that the applicable requirements of the FRA would be complied with. My detailed reasons are contained in the body of this judgment.

[9] There is also overwhelming evidence that these directors are all honest men, and that they conducted themselves at all times with unimpeachable integrity. There is not one skerrick of evidence to suggest any intention by them to mislead the regulatory authorities, market, shareholders, creditors, potential investors, or any other person.

## **FINANCIAL REPORTING ACT 1993 AND THE CHARGES**

### **Sections 36A and 40**

[10] Section 36A of the Financial Reporting Act 1993:

#### **“36A Content of statements that contain prospective, summary, or interim financial information**

(1) Any statement prepared by, or on behalf of, a reporting entity that contains prospective, summary, or interim financial information for the reporting entity must comply with any applicable financial reporting standard.

(2) Any statement prepared by, or on behalf of, a group comprising a reporting entity and its subsidiaries that contains prospective, summary, or interim financial information for the group must comply with any applicable financial reporting standard.

(3) Every director of a reporting entity commits an offence and is liable on summary conviction to a fine not exceeding \$100,000 if—

- (a) any statement prepared by, or on behalf of, the reporting entity that contains prospective, summary, or interim financial information for the reporting entity does not comply with this section; or
- (b) any statement prepared by, or on behalf of, a group comprising the reporting entity and its subsidiaries that contains prospective, summary, or interim financial information for the group does not comply with this section.

(4) This section does not apply to the extent that it is inconsistent with, or modified by, the provisions of another enactment.”

[11] Section 40 provides a defence to a director charged with an offence under any of ss 36 to 39.

#### **“40 Defences**

It is a defence to a director of an entity charged with an offence under any of sections 36 to 39 of this Act if the director proves that—

- (a) The directors of the entity took all reasonable and proper steps to ensure that the applicable requirement of this Act would be complied with; or
- (b) He or she took all reasonable and proper steps to ensure that the directors of the entity complied with the applicable requirement; or
- (c) In the circumstances he or she could not reasonably have been expected to take steps to ensure that the directors of the entity complied with the applicable requirement.”

[12] Counsel for the informant and the directors agree that s 40 places on the directors an onus to prove on the balance of probabilities that they took all reasonable and proper steps to ensure that the applicable reporting standards would be complied with.

#### **Charges**

[13] It is alleged by the Investigation Manager, National Enforcement Unit of the Ministry of Economic Development as informant that a statement prepared by, or on behalf of, Feltex (a reporting entity), containing interim financial information for Feltex, did not comply with applicable financial reporting standards (“FRS”). The charges relate to an interim accounting period being the half year ended 31 December 2005, and the interim report for that period as authorised by the Board

of Directors for distribution to shareholders and release to NZX. Specifically it is alleged:

[14] First Charge

Each of the directors faces one charge laid in the following terms:

“... that ... on/or about 20 February 2006 at Auckland and elsewhere in New Zealand did commit an offence against s 36A of the Financial Reporting Act in that he was a director of a reporting entity, namely Feltex Carpets Limited whose statement of interim financial information did not comply with an applicable financial reporting standard.

**Particulars**

**The statement of financial information:** Interim Report for half-year ended 31 December 2005 as authorised by the Board for distribution to shareholders and released to NZX.

**Financial reporting standard breached:** NZIAS 34

**Nature of breach:** Failure to disclose the breach of a loan agreement [the ANZ Bank debt facility] that had not been remedied on or before the balance sheet date. The breach being material to an understanding of the interim period.”

[15] Second Charge

Each of the directors faces a second charge laid in the following terms:

“...that ... on/or about 20 February 2006 at Auckland and elsewhere in New Zealand did commit an offence against s 36A of the Financial Reporting Act 1993 in that he was a director of a reporting entity, namely Feltex Carpets Limited whose statement of interim financial information did not comply with an applicable financial reporting standard.

**Particulars**

**The statement of financial information:** Interim Report for half-year ended 31 December 2005 as authorised by the Board for distribution to shareholders and released to NZX.

**Financial reporting standard breached:** NZIAS 34 and NZIAS 1.60.

**Nature of breach:** The classification of the ANZ Bank debt facility as “non-current” whereas it should have been classified as “current”. The breach being material to an understanding of the interim period.”

[16] The directors do not dispute and have never disputed that they were directors of Feltex at the relevant time (the issue of the 31 December 2005 half yearly financial statements), nor have they ever disputed that the 31 December 2005 half

yearly accounts were a “statement”, or that Feltex was a “reporting entity” as those terms are used in s 36A of the Act. Nor have they disputed that the breaches were “material”, nor that the requirements of the applicable financial reporting standards were not met in the two respects set out in the particulars contained in the informations.

[17] The directors rely on the statutory defence contained in s 40 of the Act and say that they have discharged the onus of proving that as directors of Feltex they “took all reasonable and proper steps to ensure that the applicable requirements of the Act would be complied with”.

## **THE LAW**

### **The relationship between the FRA and the Companies Act 1993. Are the directors entitled to rely on s 138 of the Companies Act 1993?**

[18] In their submissions concerning the application of s 40 of the FRA the directors placed reliance on s 138 of the Companies Act 1993 (“CA 93”) which, amongst other things, permits directors to rely on professional or expert advice. It is necessary to place s 138 in context.

[19] CA 93 has application in relation to companies generally. Its preamble states:

“An Act to reform the law relating to companies, and, in particular, -

...

- (a) To reaffirm the value of the company as a means of achieving economic and social benefits through the aggregation of capital for productive purposes, the spreading of economic risk, and the taking of business risks; and
- (b) To provide basic and adaptable requirements for the incorporation, organisation and operation of companies; and
- (c) To define the relationships between companies and their directors, shareholders and creditors; and
- (d) To encourage efficient and responsible management of companies by allowing directors a wide discretion in matters of business judgment while at the same time providing protection for shareholders and creditors against the abuse of management power; ...”

[20] As foreshadowed by para (d) of the preamble, s 128 requires the business and affairs of a company to be managed by or under the direction or supervision of the directors:

**“128 Management of company –**

- (1) The business and affairs of a company must be managed by, or under the direction or supervision of, the board of the company.
- (2) The board of a company has all the powers necessary for managing, and for directing and supervising the management of, the business and affairs of the company.
- (3) Subsections (1) and (2) of this section are subject to any modifications, exceptions, or limitations contained in this Act or in the company’s constitution.”

[21] Section 130 permits, subject to any restrictions in the constitution of the company, the board of a company to delegate to a committee of directors, a director or employee of the company, or any other person, any one or more of its powers other than certain powers specified in the Act as reserved to be exercised by shareholders.

[22] Section 131 provides that, subject to the section, a director of a company, when exercising powers or performing duties, must act in good faith and in what the director believes to be in the best interests of the company. Section 133 requires directors to exercise their powers for a proper purpose and s 134 provides that a director of a company must not act, or agree to the company acting, in a manner that contravenes the Act or the constitution of the company. Section 137 provides that a director of a company, when exercising powers of performing duties as a director, must exercise the care, diligence, and skill that a reasonable director would exercise in the same circumstances taking into account, but without limitation, -

- (a) the nature of the company; and
- (b) the nature of the decision; and
- (c) the position of the director and the nature of the responsibilities undertaken by him or her.

[23] Then having placed upon the directors the management obligation, having provided for delegation, having indicated how powers must be exercised and duties

performed, the Act by s 138 makes explicit that in exercising powers or performing duties the directors do not have to do everything themselves.

**“138 Use of information and advice**

- (1) Subject to subsection (2) of this section, a director of a company, when exercising powers or performing duties as a director, may rely on reports, statements, and financial data and other information prepared or supplied, and on professional or expert advice given, by any of the following persons:
  - (a) An employee of the company whom the director believes on reasonable grounds to be reliable and competent in relation to the matters concerned:
  - (b) A professional adviser or expert in relation to matters which the director believes on reasonable grounds to be within the person's professional or expert competence:
  - (c) Any other director or committee of directors upon which the director did not serve in relation to matters within the director's or committee's designated authority.
- (2) Subsection (1) of this section applies to a director only if the director—
  - (a) Acts in good faith; and
  - (b) Makes proper inquiry where the need for inquiry is indicated by the circumstances; and
  - (c) Has no knowledge that such reliance is unwarranted.”

[24] Section 138 is reflective of the common law. It also has parallels in other legislation. I was referred to Australian legislation in particular. I shall refer to the Australian legislation and some authorities in a separate section rather than disrupt the discussion of the relationship between the FRA and CA 93.

[25] Section 36A(1) of the FRA requires any statement by, or on behalf of a “reporting entity” that contains, inter alia, interim financial information “for the reporting entity” to comply with any applicable financial reporting standard. A “reporting entity” is, inter alia “(b) A company, other than an exempt company” and “company” has the same meaning as in the interpretation sections of the 1955 or 1993 Companies Acts: FRA, s 2. Under CA 93 “company” is a company registered under Part II of that Act.

[26] Not only are the two Acts tied together by the definitions in the FRA but also by provisions of CA 93.

[27] For example, see s 2 and definitions of “balance date”, “exempt company”, “financial statements”, “group financial statements”, “group of companies”, s 4 relating to the solvency test, s 80 relating to financial assistance given by a company for the purchase of its own shares, s 164 permitting the Court to make an order restraining the company or a director from engaging in conduct that would contravene the FRA, ss 170 and 172 empowering the Court to make an order requiring a director of a company, or the company, to take any action that is required to be taken by the directors under the FRA.

[28] Section 194 of CA 93 requires the board of a company to cause accounting records to be kept that will enable the directors to ensure that the financial statements of the company comply with s 10 of the FRA and that any group financial statements comply with s 13. Section 195 provides that if the records are not kept in New Zealand the company must ensure that accounts and returns for the operation of the company that will enable the preparation in accordance with the FRA of the company’s financial statements and any group financial statements and any other document required by CA 93 are sent to, and kept at, a place in New Zealand.

[29] Section 205 requires the auditor’s report to state the matters required to be stated in an auditor’s report under the FRA and statements in reports to shareholders are required to comply with the FRA (ss 209, 211, 211A).

[30] Both pieces of legislation went through Parliament together. CA 93 came into force on 1 July 1994. Part 2 of the FRA concerning preparation of financial statements (except some provisions relating to exempt companies) and Part 4 containing offence provisions including s 36 also came into force on 1 July 1994.

[31] Section 36 created offences by directors of reporting entities in relation to “financial statements”. Financial statements are defined to be statements of financial position as at balance date (FRA: ss 2 and 8) – that is, the definition of “financial statements” does not include interim financial statements. Section 36A relating to interim financial information, under which the directors have been charged, was introduced as from 15 April 2004 by s 6 Financial Reporting Amendment Act 2004.

[32] Brookers Company and Securities Law states in the introduction to the section on the Financial Reporting Act 1993 (FR Intro. 01) that:

“The Financial Reporting Act 1993 was enacted with the Companies Act 1993, forming part of the 1993 company law reform package. The purpose of the financial reporting reform contained in the Act appears to be the standardising of practices, in order to ensure consistency between different companies and other entities in financial reporting and prevent “creative” accounting practices. The Act also retains the necessary flexibility to meet the needs of the business community.

Unlike the Companies Act 1955 and its predecessors, the Companies Act 1993 does not contain any requirements relating to the contents of the financial statements prepared by companies. Those requirements are now contained in the [FRA], which applies to a number of entities in addition to companies.”

[33] In other words, instead of retaining requirements relating to the contents of financial statements in the companies legislation, they were taken out of that legislation and placed in a separate piece of legislation which had wider application than just to companies. In relation to companies CA 93 and the FRA are companions.

[34] I have no doubt, therefore, that when considering the requirements of the FRA both in relation to the creation of offences concerning the accuracy of financial statements (and later, interim financial information) and defences available to directors it is entirely appropriate to judge the conduct of directors by reference to what the Companies Act 1993 has to say about their powers of management, their duties and how they may exercise powers and perform duties.

[35] Counsel for the informant submitted that Part 8 of CA 93 “Directors and their powers and duties” relates to directors’ duties under CA 93, and that the FRA has its own regime of strict liability for the offences and its own defences. He submitted that s 138 is not applicable, is relevant only to a civil claim for breach of ‘directors’ duties’, and that this is not such a case. I do not agree.

[36] Part 8 of CA 93 comprises ss 126 to 162. For the purposes of this judgment the important provisions are those identified above. These provisions are fundamental to the way in which a company must be managed. The starting point is s 128. Subsections (1) and (2) require the business and affairs of the company to be

managed by, or under the direction or supervision of, the board of the company and gives the board all the powers necessary for managing, and for directing and supervising the management of, the business and affairs of the company. Subsection (3) provides that the earlier subsections are “subject to any modifications, exceptions, or limitations contained in this Act or in the company’s constitution”. The subsequent sections relating to delegation, directors’ duties and transactions involving self-interest represent “modifications, exceptions or limitations contained in CA 93”. Subject to those modifications, exceptions and limitations and others within CA 93, the board has all necessary management powers. This explicitly includes the power given by s 138 to rely on information and advice, subject to s 138(2). Section 138 applies when a director is exercising powers or performing duties as a director. It is not circumscribed so as to be confined to only some powers and duties. It applies whenever a director is exercising a power or duty.

[37] There is no suggestion in CA 93 or the FRA that the powers and duties specified in Part 8 are inapplicable to the exercise of powers and the performance of duties under the FRA. On the contrary, as vital requirements concerning corporate financial reporting had been moved from the companies legislation to the FRA, CA 93 and the FRA must be read together to achieve seamless integration of the requirements in CA 93 relating to the management of companies with the specific requirements in the FRA in relation to financial reporting and accounting standards.

[38] Integration of FRA ss 36A and 40 with the management provisions of CA 93, is easily achieved. Pursuant to s 40 directors have a defence if they “took all reasonable and proper steps to ensure that the applicable requirement of this Act would be complied with”. The “reasonable and proper steps” they must take could not be other than steps they are empowered to take. Their powers as directors are specified in CA 93. Section 138 applies “when [a director] is exercising powers or performing duties as a director”. Undoubtedly when dealing with a statement as referred to in FRA s 36A, the director is exercising powers or performing duties as a director.

[39] When dealing with a statement the directors are empowered to rely on professional or expert advice given by the persons specified in s 138(1) provided

they observe the requirements of s 138(2). The advice must be referable to the statement and it must be professional or expert advice. This means that if the advice is professional or expert advice and the directors act in good faith, make proper enquiry where the need for the enquiry is indicated by the circumstances, and have no knowledge that such reliance is unwarranted, they are entitled to rely on the professional or expert advice which they have received. They will then have taken “reasonable and proper steps” to ensure that the applicable requirements of the FRA would be complied with.

[40] Does this mean they will also have taken “all” reasonable and proper steps? Given the terms of s 138 it is difficult to see how they will not be held to have taken “all” reasonable and proper steps so long as they have satisfied the requirements of s 138(2) and the professional or expert advice sufficiently relates to the statement in question. There has been no suggestion that the advice on which the directors relied did not relate to the statement in question.

[41] The informant submits that the directors have not taken “all” reasonable and proper steps. Counsel lists other steps that were reasonable or proper steps which he says could have been taken and submits that they were additional reasonable and proper steps which the directors should have taken in addition to those they did take. It appears these other steps are put forward on the basis that the directors are not able to rely on s 138 of CA 93. Later in this judgment I consider the steps the directors did take, and the additional steps the informants says they should have taken.

### **Common law principles**

[42] Although there appear to be no cases considering the affirmative defence in s 40 of the FRA there are of course cases considering the standard of care expected of directors in relation to a company’s accounts, and in particular the extent to which directors are entitled to rely on the work and advice of the company’s management and external accountants or auditors when approving accounts.

[43] Cases arise from a variety of different factual situations and many involve companies and circumstances quite different from those before the Court in this case.

It is nonetheless possible to identify from these cases general principles which are relevant when applying s 40 to the facts of this case.

[44] The leading case is the decision in the House of Lords in *Dovey v Cory* [1901] AC 477. The House of Lords held that a director was entitled to rely on the accuracy of information provided to the board. The Lord Chancellor said (at 486):

“I cannot think that it can be expected of a director that he should be watching either the inferior officers of the bank or verifying the calculations of the auditors himself. The business of life could not go on if people could not trust those who are put into a position of trust for the express purpose of attending to details of management.”

[45] *Dovey v Cory* is cited in the current addition of ‘Palmer’s Company Law’ for the proposition that:

“directors are not bound to examine entries in the company’s accounting records and are entitled to rely on other officers of the company.”

[46] *Dovey v Cory* was cited and adopted by the New Zealand High Court in *Jagwar Holdings Ltd v Julian & Ors* (High Court Auckland, CP 691/91, 24 July 1992, Thorp J).

[47] The directors were sued in negligence in respect of financial forecasts in a financial profile. Thorp J held the directors did not owe a relevant duty of care but went on to consider whether there would have been a breach had a duty been owed.

[48] His Honour referred (at pp 71-72) to the reliance placed by the directors on the company’s financial controller who prepared the forecasts, and on a review conducted by Price Waterhouse. Thorp J noted:

“It was clear that none of the directors had himself checked the underlying figures, and that each had relied on the skill and probity of their Financial Controller and of PW to ensure that the forecasts were properly calculated from appropriate basic data. The question is whether that approach to their duties was itself appropriate, whether the directors were entitled to leave the preparation and checking of the forecast to [the financial controller and PW].

The answer to that question must depend in the first instance on the extent of the directors’ obligation to inform themselves about their company’s financial position, and the extent to which they could properly delegate business to other directors or the officers of the company.”

[49] Thorp J described the issue as “what is a reasonable standard of care to be observed by a director when making a statement to a third party about his company” and held (at pp 75-77):

“But even the more ardent judicial supporters of a higher standard of care than has been required in the past do not contend for more than that directors should take reasonable steps to inform themselves. The comments of the Earl of Halsbury LC in *Dovey v Cory* [1901] AC 477 at 485-86 that failure to allow directors to delegate some of their responsibilities could “render anything like an intelligent devolution of labour impossible,” and that “the business of life could not go on if people could not trust those who are put in a position of trust for the express purpose of attending to details of management,” remain basically valid to this day, even though such decisions as *Hilton International Limited v Hilton* [1989] 1 NZLR 442 and the dissenting judgment of Kirby P in *Metal Manufacturers Pty Ltd v Lewis* (1988) 13 NSWLR 315 are evidence of a growing desire to limit directors’ ability to “wash their hands” of any obligation to maintain an intelligent oversight of the company’s affairs.

It is nevertheless appropriate to recall that while directors have only limited obligations to search out information, they have always been required to pay attention and give appropriate consideration to material placed before them: see e.g. *Land Credit Company of Ireland v Lord Fermoy* (1870) LR5 Ch App 763, 770, where Lord Hatherly declared it was the duty of directors “to be awake, and their being asleep would not exempt them from the consequences of not attending to the business of the company”.

Applying those principles to the facts of this case, I note that there was no evidence suggesting that the directors should have suspected that their financial controller Mr Phan was other than a competent and reliable officer of the company with appropriate qualifications for his post. Both Mr Bauld and Mr Chalmers were asked whether they had any concern about Mr Phan’s ability or honesty. Both said they did not.

In my view it was therefore not a dereliction of duty for the directors to delegate to Mr Phan the responsibility for compiling the forecasts, all the more when they knew he was conferring with PW, and that it was to “review” those forecasts.

The next question must be whether there were special matters which should have alerted the directors to inadequacies in the forecasts and the need for some special enquiry on their part. In my view the evidence does not support an affirmative answer.”

[50] Thorp J also held (at page 80) that none of the directors had reason to doubt the integrity and competence of the company’s financial controller and that there was no reason for them to:

“... have looked behind the advice they were receiving from an apparently competent financial controller, supported in their eyes by PW’s involvement with and review of the material in question.”

## Assistance from Australia

[51] Australia's Corporations Act 2001 has a provision similar to s 40 of the FRA and s 300(2) of CA 93 in that it provides a defence to the strict liability offence of failing to keep "written financial records" (under s 286 of the Corporations Act), if it can be shown that the director took "all reasonable steps" to comply with the Act.

[52] The commentary in the 'Australian Corporations & Securities Law Reporter' discusses the scope of the "reasonable steps" test:

"A director of the entity contravenes the Act if they fail to "take all reasonable steps" to comply with, or to secure compliance with, the Act: sec 344. The Act implicitly recognises that each director cannot be expected to have personal and detailed knowledge of all aspects of the financial reporting controls within the entity, and of compliance with the accounting standards. "Reasonable steps" is not a phrase which is capable of precise definition and its meaning will differ depending upon the type of entity, the complexity of the entity's business and the internal reporting procedures within the corporate group.

The factors that a board might consider in this context are as follows:

- the use of an appropriately constituted audit committee whose responsibilities extend to overseeing the integrity of the financial reporting and control process, including internal audit. The audit committee should report directly to the board on a periodic basis, should be comprised of persons possessing financial expertise and should be structured in such a way that their decision-making processes are independent of senior executive management.
- Requiring declarations by the CEO and CFO in relation to the entity's compliance with the financial reporting requirements of the Act, and which certify that the company's internal financial controls are adequate and effective."

[53] Although not a case involving accounting records, the decision of Santow J in the Supreme Court of New South Wales in *ASIC v Adler & Ors* [2002] NSWSC 171 contains a useful summary of the relevant legal principles. Santow J set out in a series of 15 summary propositions the principles applicable to directors in exercising their duty of care and diligence in delegating tasks. Principles 8, 10 and 11 are relevant (at para 372):

- "(8) ... directors are required to take reasonable steps to place themselves in a position to guide and monitor the management of the company... That is to say ...
- (a) a director should become familiar with the fundamentals of the business in which the corporation is engaged;

- (b) a director is under a continuing obligation to keep informed about the activities of the corporation;
  - (c) directorial management requires a general monitoring of corporate affairs and policies, by way of regular attendance at board meetings; and
  - (d) a director should maintain familiarity with the financial status of the corporation by a regular review of financial statements. Indeed, he or she will be unable to avoid liability for insolvent trading by claiming that they had never learned to read financial statements: *Commonwealth Bank of Australia v Friedrich* (1991) 5 ACSR 115 at 125. ...
- (10) At general law, a director is entitled to rely without verification on the judgment, information and advice of management and other officers appropriately so entrusted. However, reliance would be unreasonable where directors know, or by the exercise of ordinary care should have known, any facts that would deny reliance on others: *Daniels t/as Deloitte Haskins & Sells* at ACSR 665-6.
- (11) Although reasonableness of the reliance or delegation must be determined in each case, the following may be important in determining reasonableness:
- (a) the function that has been delegated is such that “it may properly be left to such officers” ...
  - (b) the extent to which the director is put on inquiry, or given the facts of a case, should have been put on inquiry ...
  - (c) the relationship between the director and the delegate must be such that the director honestly holds the belief that the delegate is trustworthy, competent and someone on whom reliance can be placed. Knowledge that the delegate is dishonest or incompetent will make reliance unreasonable ...
  - (d) the risk involved in the transaction and the nature of the transaction ...
  - (e) the extent of steps taken by the director, for example, inquiries made or other circumstances engendering “trust”;
  - (f) whether the position of the director is executive or non-executive ... though, in *Daniels v Anderson* (1995) 16 ACSR 607, the majority have moved away from this distinction.”

### **Material conclusions from the authorities**

[54] The general thrust of the material referred to in paras [42] to [53] so far as relevant to this case is that directors must exercise intelligent oversight of the company’s affairs. They must pay attention and give appropriate consideration to material placed before them. They are entitled to impose trust in others so long as they take reasonable steps to ensure that such trust is warranted and are not alerted to reasons why the trust may be misplaced.

[55] However what is important in this case are those factors which have been codified for New Zealand in CA 93 as referred to earlier. Of critical importance are these principles:

- (a) Directors may rely on employees believed on reasonable grounds to be reliable and competent and on professional advisers and experts in relation to matters believed on reasonable grounds to be within the person's professional or expert competence. They may also rely on any other director or committee of directors in relation to matters within the director's or committee's designated authority: s 138(1) CA 93.
- (b) But the ability to rely upon such persons is subject to important limitations. Section 138(2) CA 93 makes it clear that where a director may rely on material coming from the class of persons listed in s 138(1), ie (a) an employee of the company; (b) a professional advisor or expert; or (c) any other director or committee of directors upon which the director did not serve in relation to matters within the director's or committee's designated authority he may do so only if the director:
  - (i) acts in good faith; and
  - (ii) makes proper inquiry where the need for inquiry is indicated by the circumstances; and
  - (iii) has no knowledge that such reliance is unwarranted.

This is in essence a succinct legislative statement of principles developed by the common law.

## **MATERIAL BACKGROUND FACTS**

### **Importance of temporal context in which the statement was prepared**

[56] The preparation and subsequent presentation of the half year accounts of Feltex to 31 December 2005 occurred during a period of intense shareholder and financial market attention that followed Feltex's public listing and subsequent

deterioration of trading performance during the first half of 2005, leading to the issue of revised and reduced forecasts of profitability.

[57] During this period the Feltex directors were under pressure to turn the deteriorating business performance around. To that end they had initiated some restructuring measures designed to do so, the most significant of these being the closure of a manufacturing plant in Melbourne. The planned restructuring measures led to discussions with Feltex's bank, the ANZ, and a renegotiation and extension of Feltex's borrowing facilities such as to include a new short term facility enabling Feltex to undertake the planned restructuring and to meet the associated costs.

[58] Feltex, including the directors, and the ANZ Bank were both well aware that the additional borrowing provided for under the new short term facility would mean that Feltex would not be able to adhere to or comply with its existing banking covenant ratios, thereby putting Feltex in breach of those covenants unless the ANZ Bank waived the breaches or there was a renegotiation of the way in which the ratios were to be calculated. The evidence is equivocal as to whether there would have been a breach even without the additional borrowing but, in my view, it must have been known that this would be a possibility at least. At no stage in their evidence and in no way did the directors seek to fudge this possibility.

[59] The directors were well aware that the half year accounts would be subjected to close scrutiny by a host of professional market analysts, shareholders, and others who had been following the company's progress.

[60] Equally importantly, as at December 2005, New Zealand was in a transition period from its previous accounting standards ("GAAP") to the adoption of the New Zealand equivalent of International Financial Reporting Standards ("NZIFRS"). Under the transition rules that applied to Feltex, the group was required to adopt NZIFRS for its financial year commencing 1 July 2007, and had the option of adopting NZIFRS as early as its financial year commencing 1 July 2005. Feltex chose to early adopt NZIFRS and its 31 December 2005 interim financial statements were therefore its first financial statements prepared under NZIFRS.

[61] This made Feltex one of the first New Zealand companies to report under NZIFRS.

[62] Up until the change to NZIFRS, GAAP had applied to reporting standards in New Zealand. Equivalent standards had operated in Australia. The previous standards, which had prevailed for many decades, favoured substance over form but NZIFRS, in respect of the standards relevant to this case, appear to favour form ahead of substance.

[63] With regard to classification of liabilities, far from being simply a change to the terminology to be used in the accounts, the terminology in fact remained the same while the underlying definitions of current and non-current liabilities underwent a fundamental change in approach.

[64] Under the previously applicable GAAP standards, the test represented a substance over form approach by which the liability would be assessed on the basis of the expectation as to whether the company would be required to repay in the upcoming twelve months. Therefore, regardless of the strictly applicable legal terms of the relevant facility, a company could still legitimately classify debt as non-current if it reasonably expected that the debt would not be called up in the next twelve months. By contrast the requirement under the IFRS standards is that the reporting entity have an unconditional right to defer the repayment of the debt for at least twelve months. This created a much more stringent test and was a significant shift in the governing principles of debt classification.

[65] The business community in both New Zealand and Australia but particularly in New Zealand were not yet generally au fait with the significant change in the emphasis of the standards. Thus the directors were operating on the basis of what they knew under the old standards and because they had received incorrect advice from their specialist advisers.

[66] Obviously over time, as more companies adopted NZIFRS and when all were required to comply with the new standards, these changes would become widely known and many directors would become conversant with these material changes.

However as at February 2006 these directors, Feltex's management, and as it turns out the company's external professional advisors, were not sufficiently conversant with the implications of adopting NZIFRS. The newness of the new standards and the significant changes which they effected made the situation especially difficult.

[67] The temporal context should not obscure a more fundamental point, to which I return later in the judgment. The standards are highly technical. Interpreting and applying them, and ensuring financial statements comply with them, are specialist activities. Company directors are entitled to rely on specialist advice and, indeed, in many cases they would be failing to take reasonable and proper steps if they approved financial statements without obtaining specialist advice.

### **ANZ Bank facility**

[68] Feltex had a number of loans from the ANZ Bank dating back to the early 1990's. In October 2005, ANZ reduced one of Feltex's loans by A\$5 million and loaned Feltex A\$10 million as a short term facility. Feltex and ANZ also amended the terms of their loan facility agreement. The revised agreement was reflected in the Fourth Deed of Amendment and Restatement of Facility Agreement ("fourth restatement").

[69] As at the 31 December calculations date, Feltex had breached certain of its banking covenants. And as at the date the interim financial statements were issued, ANZ had not unconditionally waived its rights in respect of Feltex's breach. It was not until May 2006 that ANZ formally notified Feltex that ANZ had waived its rights in regard to Feltex's breach. There was no reporting of the breach of covenants in the interim financial statements – this gave rise to the first charge.

[70] The breach of covenants under the facility documents in the fourth restatement entitled ANZ to demand repayment of all of the borrowings. Accordingly, Feltex did not have an unconditional right to defer settlement of its liability for at least twelve months after the reporting period. Therefore Feltex could not classify the liability as non-current under NZIAS 34 and 1.60. But it was classified as non-current – this gave rise to the second charge.

### **Feltex's expectations of ANZ at material time**

[71] In para [6] I noted that the evidence concerning the dealings between the company and the ANZ Bank demonstrates that during the material time Feltex's directors and management, and indeed their specialist accounting advisers Ernst & Young, were entitled to and did hold the view that ANZ would not be relying upon its strict legal rights and would be providing continuing support for the company. The dealings between the ANZ Bank and Feltex were largely conducted for the bank by Mr Holland who was head of a division known as "Corporate Portfolio Management". That division looks after the "problem or distressed loans of ANZ". I now turn to outline why the evidence entitled Feltex's directors and management, and Ernst & Young, to hold the view that ANZ would not be relying on its strict legal rights, and would be providing continuing support for the company.

[72] I have already referred to the planned restructuring measures and the awareness of the directors and the ANZ Bank that Feltex would not be able to adhere to or comply with its existing banking covenant ratios, thereby putting Feltex in breach of those covenants unless the bank waived the breaches or there was recognition of the way in which the ratios were to be calculated. This was known as early as June 2005.

[73] The attitude of the bank as conveyed to Feltex was a desire to work with management and the board to find a solution "and to align our expectations, goals and establish meaningful milestones" (letter from Mr Holland to Feltex dated 7 July 2005). The bank specifically noted by a letter dated 7 September 2005 that the "existing financial covenants may need to be flexed as part of the restructure". What this meant was that the bank was recognising that it may need to relax the financial covenants. This was the converse of any suggestion that the covenant breaches would be relied upon as an act of default. On the contrary the impression was being given that the covenant breaches would not be relied upon and that appropriate steps of some sort would be taken to regularise the situation. It is clear that Feltex could reasonably have had the impression that the bank was generally supportive and would not be exercising its strict legal rights.

[74] The following further actions, taken from Mr Holland's evidence, were relied upon by Mr Galbraith.

- He conceded that from Feltex's perspective, at a 27 June 2005 meeting the bank was indicating that it would continue to support the company;
- He accepted that Feltex would have taken a message of support from ANZ's 7 July 2005 letter;
- He accepted that a reader of ANZ's 7 September 2005 letter to Feltex would assume that the bank was forecasting a concession, ie, a flexing of the covenants;
- He conceded that the documents appeared to show that Shane Groves of the ANZ told Peter Thomas in a meeting on 24 August 2005 that ANZ would flex the covenants;
- He agreed that as at October 2005, there was no intention on the part of the ANZ to call in its loans to Feltex, but rather the bank thought that Feltex management was acting sensibly and deserved its support; and
- He accepted that it was reasonable for the Feltex directors to have concluded that they could rely on the support of the bank at the time of the AGM in December 2005.

[75] In answering questions from counsel and from the Court, Mr Holland confirmed that during the period material to the preparation and acceptance of the financial statement the bank's behaviour was such as to create the impression that the bank was not going to act on the breaches of covenant. There was ample material demonstrating that although the bank had concerns, it would be continuing to present a positive and supportive position to Feltex. It was not until well after Feltex had announced its interim half year results on February 2006 that the relationship between the bank and Feltex deteriorated. The bank's attitude hardened in late March 2006.

[76] That Feltex had the impression that the bank was generally supportive and would not be exercising its strict legal rights and that this impression was reasonable is confirmed by Ernst & Young's view of the situation. There is much material to show that Ernst & Young held the same view as Feltex's management and directors. Perhaps to a large extent that was as a result of what was conveyed to them by Feltex's management but, even so, it confirms that Feltex's management held the view and that there was no reason to think that it was an unreasonable view to hold.

**REASONABLE AND PROPER STEPS TO ENSURE COMPLIANCE:  
WHAT STEPS DID THE FELTEX DIRECTORS TAKE?**

[77] In seeking to demonstrate that the directors took all reasonable and proper steps to ensure that the applicable requirements of the FRA would be complied with, counsel for the directors submitted that in ensuring or attempting to ensure full compliance with IFRS and the FRA the directors:

- placed reliance on a qualified, competent and well-resourced financial management team;
- established a comprehensive transition process from GAAP to IFRS;
- engaged a highly reputable accounting firm (Ernst & Young) to prepare an IFRS assessment report identifying key areas and issues that needed to be addressed in the transition to the new IFRS standard so as to ensure compliance;
- created and established a steering committee comprising Feltex's own financial management and supervised by Ernst & Young who would actively advise, educate, assist and participate in the review of all the IFRS standards applicable to Feltex and to take measures to ensure compliance;
- engaged Ernst & Young to undertake a review of the 31 December 2005 half year accounts with a particular emphasis on compliance with the new IFRS accounting standards;

- obtained declarations by the CEO and CFO in relation to Feltex's compliance with the FRA which certified that the company's internal financial controls were adequate and effective;
- used an appropriately constituted audit committee whose responsibilities extended to overseeing the integrity of the financial reporting and control process;
- and in respect of the directors Thomas and Feeney, neither of whom were members of the audit committee, relied on the recommendation made to the board by the audit committee that the interim half year accounts were accurate and fully compliant with IFRS standards before taking the decision to approve and issue the accounts.

I consider each of these in turn.

**Placed reliance on a qualified, competent and well resourced management team**

[78] The directors had ensured that the company operated a well resourced financial management team, headed by its chief financial officer, Mr Tolan. Before taking up the position of Feltex's chief financial officer, Mr Tolan had been financial controller of Feltex's manufacturing business in New Zealand. He had qualifications of Bachelor of Commerce and a postgraduate diploma in accounting from the University of Natal. He was appointed CFO of Feltex in April 2002 and held the position through until the company was placed in receivership in September 2006. Before joining Feltex he held the position of audit manager with the international accounting firm Deloitte & Touche in South Africa. At Feltex he was responsible for leadership and supervision of the company's finance department which employed approximately 15 accountants and accounting staff. He was assisted by two senior managers, Lynn Ruddell, the group financial controller, and Geoff Cook, the tax treasury manager.

[79] Ms Ruddell herself is a qualified chartered accountant and the standard of her work was such that she received frequent compliments from Feltex's auditors, Ernst & Young, on her skills and the quality of her work product.

[80] Mr Painter (a partner of Ernst & Young Australia, and Feltex's principal external accounts adviser) was complimentary of Mr Tolan's competence both as to the quality of his management and the quality of the financial information that he was presenting from both a management and accounting point of view. Mr Painter said that the Feltex financial management team were both competent and sufficiently well resourced to generate the sort of management financial information required for a company the size of Feltex. It was Mr Painter's assessment that the directors, this board of directors, had every reason to consider that the financial management team that were reporting to them were a competent operation.

[81] Mr Painter confirmed in his evidence that Mr Tolan and the other members of Feltex's finance department were competent, open and transparent in their dealings with Ernst & Young and well resourced. He confirmed that on a number of occasions he had complimented Mr Tolan and Ms Ruddell to the board on the quality of their work. The directors had also received these assurances directly in writing from Ernst & Young. At the time of the previous audit of Feltex's year-end accounts to 30 June 2005 Ernst & Young had written to the audit committee of the Feltex board stating:

“We received complete co-operation from the company personnel in completing our audit procedures. In particular, the high quality of assistance received from the company's chief financial officer was greatly appreciated.”

[82] A similar letter had been sent by Ernst & Young to the directors at the time of the 30 June 2004 audit.

[83] Similar praise for the work of Mr Tolan and Ms Ruddell was given orally by Mr Painter at the audit committee meeting on 16 February 2006. Mr Thomas said of that meeting:

“There was some discussion thereafter about the performance of the accounting team in both the transition to IFRS and I believe the preparation of the accounts. As Chief Executive, which I was at that time, it was pleasing but you know I heard what I expected to hear and that's that Des Tolan had done a good job and that there was special praise for Lynn Ruddell for the effort that she had put into the accounts in the IFRS transition.”

That praise was recorded in the minutes of the meeting.

[84] The directors had employed a qualified, well resourced and competent finance department under the leadership of an experienced chief financial officer. They had no reason to doubt the quality of the financial statements prepared by the finance department, and were repeatedly assured by Ernst & Young that the finance department was performing that function to a high standard. Each of the directors confirmed in their evidence the trust that they had in the diligence and competence of Mr Tolan and his department. On the evidence available to me, therefore, each director believed on reasonable grounds that the chief financial officer and the two senior managers, Lynn Ruddell, the group financial controller, and Geoff Cook, the treasury manager were appropriately qualified, well resourced and competent. In doing so they acted in good faith, they made proper inquiry of the management team, and they had no knowledge that such reliance in this instance would prove to be unwarranted.

#### **Established a comprehensive transition process from GAAP to IFRS**

[85] In 2004, the then chairman of the Audit at Risk Committee, Mr Craig Horrocks, had taken the initiative in establishing “a vigorous programme” to get Feltex ready for the transition to IFRS. In anticipation of the move to IFRS the directors of Feltex engaged Ernst & Young to provide advice and ongoing assistance with an IFRS transition programme. The decision to engage Ernst & Young in this role was made at the meeting of the audit committee on 18 August 2004, approximately 18 months before Feltex would first issue financial standards under IFRS.

[86] As with many meetings of the audit committee that meeting was held at Ernst & Young’s offices in Melbourne and was attended by Mr Painter and Ms Herman, the Feltex senior manager in the employ of Ernst & Young. In a letter dated 5 October 2004, Ernst & Young set out the proposed benefits of such a transition project. The first sentence explained that the letter was intended to:

“... outline our approach to assisting you with Feltex Carpets Limited’s planned conversion of its financial accounting and reporting to conform with the International Financial Reporting Standards (IFRS).”

Ernst & Young then lists the benefits of an integrated and structured approach to conversion to IFRS including to:

“... ensure greater assurance for management and the board through independent and credible assessment by our specialists.”

[87] The “specialists” identified in the letter were Mr Painter, the Feltex audit partner, Ms Herman, the Feltex senior manager, and Ms Pozzie, an IFRS technical specialist. The directors were entitled to rely on these experts. They were part of a specialist team who had years of training and whose past performance had demonstrated just the requisite level of competence to undertake the transition process on the company’s behalf. In instructing this expert team from Ernst & Young I find the directors were entitled to believe on reasonable grounds that the work to be undertaken was within their professional and expert competence and that the transition would be undertaken successfully and would ensure ultimate compliance with IFRS.

[88] Having elected to become an early adopter of IFRS the directors of Feltex recognised the need to carry out a thorough transition process including a review of the company’s previously prepared accounts and a process to upskill internal accounting staff with the assistance of external advisors. To this end, the board committed to measures which were intended to ensure that the accounts produced for the period ending 31 December 2005 were prepared in complete compliance with the new IFRS standards.

[89] Feltex appropriately recognised that the transition to IFRS represented a significant change in accounting practices and therefore allocated substantial time and resources to its transition project. Mr Painter confirmed that IFRS represented a “sea change” and that Feltex was “very prudent” in getting training and assistance. The complexities involved in such an accounting transition were in Feltex’s case compounded by the fact that as an “early adopter” of the new standards Feltex was one of the first companies in New Zealand to convert to the new IFRS standards.

[90] The complexities of a transition to IFRS were identified in the Ernst & Young engagement letter dated 20 June 2004 in which it is stated:

“As we have discussed, converting your financial accounting and reporting systems to conform with IFRS requires a tremendous commitment of management’s time and energy. Further, converting to IFRS necessarily means that there are a number of significantly different financial accounting and disclosure requirements that will result in important financial statement differences.”

[91] Feltex’s transition project comprised two separate steps, the first being the commissioning of an IFRS Impact Assessment Report from Ernst & Young which was then to be followed by the establishment of a steering committee which was to conduct a standard by standard review wherein a member of the Feltex financial management team was to be supervised by a qualified senior manager from Ernst & Young.

**Engaged a highly reputable accounting firm (Ernst & Young) to prepare an IFRS assessment report identifying key areas and issues that needed to be addressed in the transition**

[92] Ernst & Young were engaged to conduct an IFRS assessment report based on the 30 June 2004 annual report, being the most recent available audited annual report. The fee for the report was to be A\$25,000 as set out in the engagement letter.

[93] The complete IFRS assessment report dated 2004 comprising 55 pages was provided to the committee and was discussed during a meeting of that committee on 8 December 2004. An abridged version of the report was also provided to the board of directors. The introduction to this report (page 3) noted that Feltex would need to adopt IFRS early, and described the report as a “high level review and impact assessment designed to determine the main IFRS issues that [Feltex] needs to address”. The executive summary states:

“The results of the diagnostic has:

- Identified the major Generally Accepted Accounting Principles (“GAAP”) differences and assessed where [Feltex] current financial reporting will be impacted by IFRS.
- Provided base information to facilitate the structuring of the IFRS conversion project within [Feltex].
- Identified areas requiring further investigation and impact evaluation which should be addressed in the next phase of the project.

- Raised awareness of the IFRS issues within [Feltex] and given momentum to the IFRS conversion project.”

[94] Ernst & Young is known in the vernacular as “one of the top four”, meaning one of the top four international firms. In employing a highly reputable accounting/audit firm, and in relying on Ernst & Young’s expertise to inform the Feltex board, the directors acted in good faith and they made proper inquiry by requesting a report as to how to present financial statements under IFRS. They had no knowledge that such reliance would turn out to be unwarranted.

**Created and established a steering committee comprising Feltex’s own financial management and supervised by Ernst & Young**

[95] As recognised by Mr Painter, a number of reporting entities elected to conduct aspects of their transition programme internally so as to create a knowledge base within the organisation and thereby avoid being entirely dependent upon external advisors. In line with this approach Feltex elected to conduct a standard by standard review of IFRS within their accounting and finance department. Mr Painter has suggested in his evidence that Ernst & Young did not have a continuing involvement in this aspect of the transition process. However it is apparent that the steering committee papers that were passed up to the audit committee were checked by a senior member of Mr Painter’s team at Ernst & Young, Ms Rene Herman.

[96] Ernst & Young’s involvement in the steering committee process is further confirmed in the audit report of June 2005 which states:

“We have however reviewed management’s executive summary papers and have been involved throughout management’s NZIFRS transition process.”

[97] The steering committee process was clearly one which was to involve Feltex’s internal finance and accounting staff in doing the ground work of the standard by standard review with Ernst & Young supervising that work and reviewing the work product for accuracy and completeness.

[98] Management and the directors could therefore take comfort from the fact that their staff were being educated and upskilled in relation to IFRS through the steering committee review process and from the fact that this education was being monitored

and overseen by Ernst & Young. The work conducted by the members of the steering committee was conducted at an appropriate skill level and by individuals involved with the relevant aspects of the business. This meant issues in relation to inventory were dealt with by those with direct dealings and knowledge of the company's accounting processes in this area, while Treasury issues were dealt with by those with a responsibility for those aspects. Further the staff who were involved including the group financial controller, Ms Lynn Ruddell, were highly qualified and experienced and had been complimented on their work by the company's advisers Ernst & Young in relation to their involvement in the transition project.

[99] The steering committee process was intended to consist of a thorough ongoing review of each of the standards having particular regard to the issues that would be of significance to Feltex. The purpose of the steering committee is stated in their papers as:

“The objective of this review is to understand the requirements of accounting for borrowing costs under the new international accounting standards, how it compares to current accounting practices, and to understand the possible financial outcomes and the effect on the business decision of Feltex. It is also a mechanism for transferring information to the board, management and other Feltex accountants.”

[100] The steering committee process spanned many months and many hours of work by both internal and external accounting advisers. The transition process from the audit committee in broad perspective appeared to be a robust and effective process by which Feltex would obtain an understanding of the IFRS requirements and ensure the company's accounts complied with the new standards. There was therefore no utility for either management or directors to go behind the work completed. It was therefore reasonable for the directors to believe that they had taken all reasonable steps to embed adequate knowledge of IFRS in Feltex.

**Engaged Ernst & Young to conduct a review of the Feltex half year accounts to 31 December 2005**

[101] Ernst & Young were thus ideally placed to provide competent professional advice on Feltex's interim financial statements. This was an additional step taken by the directors, a voluntary step taken by them to secure an additional layer of assurance that their accounts complied with the new standards. In fact it was

Mr Painter who suggested to the audit and risk committee of the board on 15 June 2005 that Ernst & Young be engaged to undertake such a review. The minutes of that meeting record:

“E&Y suggest Feltex should consider undertaking a half year review in the future. This may assist in re-establishing credibility with the financial markets.”

[102] The formal resolution to engage Ernst & Young in that role was then made at the meeting of the full board of directors on 31 October 2005 which was also attended by Mr Painter.

[103] A formal engagement letter was prepared by Ernst & Young dated 7 December 2005. The letter was addressed to Mr Hunter as chairman of the audit committee and described the scope of review as follows:

“You have requested that we perform the following procedures for Feltex Carpets Limited and report to you on the results of our work: review the financial statements of Feltex Carpets Limited as at 31 December 2005 and for the period then ended.

As agreed we will conduct a review, consisting primarily of inquiry, analytical procedures and discussion, in accordance with the review engagement standards issued by the Institute of Chartered Accountants of New Zealand.

The review does not constitute an audit. Accordingly our review is not intended to, and will not, result in either the expression of an audit opinion or the fulfilling of any statutory audit requirements.”

[104] The letter provided for fees payable to Ernst & Young for the review of A\$85,000 plus GST (although the actual fees charged were A\$113,000 plus GST). Mr Painter described this as a “fully properly constituted engagement to undertake a review” and acknowledged the reliance the directors were putting on Ernst & Young’s conduct of the review. The following passage is from his cross-examination:

“Q. ... Am I right that you were given a clear message from members of the audit risk management committee that they were looking at this review process as a means which would give them an additional level of confidence that the IFRS requirements had been adhered to?

A. It was their first set of financial statements under IFRS so yes.

- Q. So there ... can't be any doubt ... that they were looking to Ernst & Young to provide the expertise, acknowledging that it was a review and not an audit?
- A. Some of the expertise yes. I mean that's why we get paid to undertake reviews and audits yes ..."

[105] The minutes of the audit committee meeting held on 28 November 2005 (again attended by Mr Painter) record that Ernst & Young was to "conduct preliminary review onsite" prior to 31 December 2005 and that the review was then "scheduled to commence 16 January 2006 through until 31 January 2006".

[106] It follows that Ernst & Young was required to have a detailed and up to date knowledge of IFRS so as to be able to form a view that, based on the information available, the standards had been complied with.

[107] In order to achieve that level of expert knowledge, audit partners and staff in major accounting firms participated in extensive training on IFRS. Mr Painter gave evidence of the "demanding" and "detailed" training at Ernst & Young with subsequent updates, lectures and testing with "various levels of accreditation". He then said:

- "Q. I take it then that Ernst & Young saw this introduction of IFRS as something of a sea change in terms of audit requirements and the technical aspects that it was going to introduce?
- A. Yeah I mean the whole industry did yes ...
- Q. Because without that sort of comprehensive education, people would be left to flounder around through a pretty extensive and technical set of rules, am I right?
- A. Yes that's why we had the programme, yes.
- Q. And having done that, you – that is Ernst & Young, had a body of people who were at least presumed were skilled or upskilled and were able to go out and start giving advice as to the requirements of IFRS?
- A. To undertake reviews and audits in accordance with the new standards, yes."

[108] Similarly Mr Prichard (a partner of the accounting firm KPMG) referred to a "heavy emphasis of training of audit staff and other staff on" IFRS over a two to three year period. Notwithstanding this training of all audit staff, Mr Prichard also

explained the role played by the “technical department” within an accounting firm to provide specialist support on accounting standards to the audit partners and staff.

[109] Clearly company directors will not have anywhere near the same level of knowledge and expertise in accounting standards that a specialist auditor will have and the best course for a director is to seek and follow the advice of an expert.

[110] Ernst & Young’s review report was provided to the members of the audit committee prior to the meeting scheduled for 16 February 2006. The report, with a pack of materials provided to the audit committee members was produced.

[111] Ernst & Young’s covering letter sent with their review report is addressed to the audit committee and says it:

“... is intended solely for the use of the audit and risk management committee, other members of the board of directors and local management team.”

The opening paragraph of the report itself reads:

“This report has been prepared for the management and audit and risk management committee (“ARMC”) of the “Feltex Group” ... to provide a summary of our findings in conducting our review for the six months ended 31 December 2005.”

[112] The report confirms that particular focus has been given to IFRS and that Ernst & Young have noted no significant issues with IFRS compliance. There is a list of issues – described as “audit differences” – in appendix 1, but these are all minor and irrelevant matters and the report notes that these “are not material and as such do not require adjustment by management”.

[113] Any reasonable reader of that report would conclude that Ernst & Young had conducted a proper review which had not revealed any issues with IFRS compliance.

[114] Ernst & Young’s report and the interim financial statements were then discussed by the audit committee at the meeting on 16 February 2006. This was held in Ernst & Young’s offices in Melbourne and was attended by the audit committee members (Messrs Hunter, Saunders and Hagen), Mr Thomas (who arrived late with Mr Saunders), Mr Tolan, Ms Ruddell, Mr Painter and Ms Herman.

[115] The agenda for the meeting notes the matters to be reviewed in the meeting including the “Ernst & Young review closing report”, “balance sheet review”, and a “general update” in relation to IFRS. The minutes show that the meeting commenced at 11.30am and finished at 4pm. Under the heading “Ernst & Young review closing report” the minutes record “IFRS review completed”. And under the subheading “international financial reporting standards” the minutes record “all adjustments have been captured”. Under the heading “balance sheet review” the minutes record “no issues”. Under the heading “IFRS” the minutes record “IFRS impact validated by E&Y” and “appreciate the efforts of Lynn Ruddell and Des Tolan in readying Feltex for transition to IFRS”.

[116] Mr Thomas gave evidence about a direct question he put to Mr Painter at the meeting on 16 February 2006:

“A. Well I went to the meeting. I do not have a great recollection of everything that was discussed at that meeting. I can remember the layout of the room and where people were sitting. I can remember some discussion at the meeting. I am aware that the bank, when I came into the room and Tim came into the room, there was some discussion about the bank relationship. I waited through the discussion of the meeting until there was – you know, it was obvious that the meeting was coming to a close and then I asked if I could ask a question and I looked at Mr Painter and I said “can you assure me that these accounts comply with IFRS?” and –

Q. What was his response?

A. He looked straight back at me and I looked at him and he said “yes”.

Q. What happened then?

A. I was relieved. There was some discussion thereafter about the performance of the accounting team in both the transition to IFRS and I believe the preparation of the accounts. As chief executive which I was at the time, it was pleasing but you know I heard what I expected to hear and that’s what Des Tolan had done, a good job and there was special praise for Lynn Ruddell for the effort that she had put into the accounts and to the IFRS transition.

Q. And so once the meeting was over what did you do?

A. I went downstairs and I called a taxi and I went straight home to bed. “

Mr Thomas was at that time most unwell. He had contracted dengue fever during a visit to Pāpua New Guinea, had been hospitalised for a period, and was still recuperating.

[117] When it was suggested to Mr Thomas in cross-examination that it was unlikely he sought a complete assurance from Mr Painter, Mr Thomas said:

“I reject that statement Mr Dickey. My question to him was specific. I looked at him when I asked it, his answer was a single word, “yes”. It wasn’t yes but, yes maybe, yes nothing’s come to my attention. The answer to this question which was put to him as reviewer and as IFRS expert the answer was “yes”.

[118] That evidence of an express assurance from Mr Painter was confirmed by Messrs Tolan, Saunders, Hunter and Hagen. Mr Painter said that at the time of the 16 February 2006 meeting he was satisfied that the accounts complied with IFRS and would have said so to the directors if asked. I quote:

“Q. So any questions you were being asked about you were giving reassurance. These draft accounts and important interim reports were all ok?

A. Based on what was presented to us at the time, yes.”

[119] It was clear from his answers that he did not have a clear recollection of the events of the meeting. He could not for example recall that Mr Thomas and Mr Saunders arrived late from their other meeting. When Mr Thomas’s direct question about IFRS compliance and his affirmative answer were put to him in cross-examination he said he was unable to recall whether he said that or not (though then added that he doubted whether he would have used the word “assurance”). I find that an unequivocal assurance was given.

[120] A reasonable director having read Ernst & Young’s review report and attended the meeting on 16 February 2006 would have been left in no doubt that the interim financial statements prepared by the company’s management and reviewed by Ernst & Young fully complied with IFRS. As Mr Tolan said in his evidence:

“The impression left by the meeting was that the directors could be completely confident that the interim financial statements complied fully with IFRS”.

[121] Thus I find that the directors acted in good faith obtaining a review from one of the top four accounting firms, that they made proper inquiry where the need for inquiry was indicated, and that their reliance on the reassurance of the reviewers was warranted in the circumstances.

[122] The informant suggested that it was insufficient for the directors to engage Ernst & Young to conduct a review and not an audit. I do not agree. If a properly conducted review had been undertaken it would have identified the relevant errors in the financial statements for the reasons previously discussed. The directors took the appropriate step of obtaining expert advice which, had the engagement been undertaken to the proper professional standard which the directors were entitled to expect, would have identified the errors which would then have been corrected.

[123] Furthermore as Mr Hullah (a former senior partner of Deloitte and an expert in the audit and advisory needs of large national and multi-national companies) pointed out in his evidence there was no relevant difference between an audit and a review in this case. With an issue such as a covenant breach the reviewer's obligation is to make the necessary inquiries to ensure that the accounting implications of the breach are fully identified.

[124] With a few exceptions companies do not have their interim financial statements audited (and indeed most of them did not have them reviewed in 2005/2006). An examination undertaken by Mr Hagen of the interim financial statements of all companies in the NZX50 (ie the 50 companies listed on NZX with the largest market values) over the past five years 2005 to 2009 shows:

- (i) In every year but one (2008), no company had their interim financial statements audited.
- (ii) In 2008 one company, Contact Energy, had its interim financial statements audited. This was because Contact was about to offer debt securities of \$550 million to the market by public offer, and the interim financial statements were audited for inclusion in the prospectus for that public offer. Contact Energy did not have its interim financial statements audited in any other year.
- (iii) In 2005, 34 percent of NZX50 companies had their interim financial statements reviewed. That percentage has increased each year and in 2009 55% of NZX50 companies had their interim financial statements reviewed.

[125] The obligation on the Feltex directors to take “all reasonable and proper steps” cannot require them to obtain an audit of the company’s half-yearly accounts in circumstances where no other company directors take that step.

[126] It was entirely reasonable for the directors to expect that the Ernst & Young review engagement would provide assurance that the accounts complied with IFRS and that any potential errors would be identified and corrected. They were entitled to expect that errors such as those giving rise to the changes would be detected. Had they been detected they would have been corrected and the financial statements would have complied with IFRS.

**Obtained declarations by the CEO and CFO in relation to Feltex’s compliance with the FRA which certified that the company’s internal financial controls were adequate and effective**

[127] As I have previously said the directors caused Feltex to employ a competent and qualified finance department to prepare financial statements and had put in place a prudent transition process overseen by Ernst & Young to ensure that Mr Tolan and his team were familiar with the new IFRS standards.

[128] By presenting the draft financial statements to the audit committee Mr Tolan and Ms Ruddell were representing to the audit committee and the board that the statements were compliant with IFRS (quite apart from the separate advice obtained from the Ernst & Young review). Mr Tolan was the senior executive with overall responsibility for both financial reporting and the relationship with the bank, and the directors reasonably relied on him for those matters.

[129] Mr Tolan accepted responsibility for his part in the poor advice received by the directors. In accepting responsibility he said this:

“Well I accept that it was part of my role to present the financials to the board which I did and I did represent to the board that they were compliant with IFRS but that representation was drawn from the representation that Lynn Ruddell had made to me and more importantly, the representation that Ernst & Young had made to us.”

[130] In examining the directors’ responsibilities - they acted in good faith at all times. They did make the requisite inquiry of the CFO, Mr Tolan and the CEO at the

relevant time, Mr Thomas. They sought and obtained declarations from both of them that compliance with FRA was assured. Mr Tolan and Mr Thomas had demonstrated themselves to be competent and reliable in such issues previously. There was nothing to put the directors on notice that any further inquiry was needed or that they were not entitled to rely on the declarations. There is nothing in the evidence to suggest they knew their reliance would turn out to be unwarranted.

**Used an appropriately constituted audit committee whose responsibilities extended to overseeing the integrity of the financial reporting and control process**

[131] There is no dispute that Feltex had a properly constituted audit committee that reported appropriately in a diligent and competent fashion to the board on a periodic basis. It comprised persons possessing financial expertise and it was structured in such a way that its decision-making processes were independent of senior executive management.

[132] It was the audit committee that made the decision to engage Ernst & Young to undertake a review of the interim financial statements. The audit committee meetings often took place at Ernst & Young's offices in Melbourne and Mr Painter attended every meeting. Ms Herman also attended the meetings, as did the CFO.

[133] It is evident from reviewing the audit committee minutes that there was significant attention paid by that committee to the implications of early adoption of IFRS. I refer to paragraphs [135] to [142] inclusive which show that proper inquiries were being undertaken by management and directors who served on that committee. As Mr Hagen put it "we asked the right questions and we got the wrong answers".

[134] Mr Hullah was cross-examined at some length as to the division of responsibilities between members of an audit committee and the company's auditors. He rejected the proposition that the directors should be expected to "join the dots" between the known facts and the financial reporting implications of those facts, where he said:

"I would expect an experienced interpreter of the accounting standards to understand that the waiver has to be – well in my opinion would have to be in a written form and by the conduct of the banks, because I think that's an

issue which is in question here, but the conduct of the banks to someone who deals with those accounting standards regularly and understands how they should be applied would believe that the waiver should be issued before the 31<sup>st</sup> of December and should also be in a written form. Now whether it's reasonable to expect even an experienced company director to understand that implication of the accounting standards is not something that I think is a fair assumption."

[135] It was also put to Mr Hullah that the audit committee was some form of expert advisory body which provides assurance to the company on financial reporting issues. This proposition was also rejected by Mr Hullah:

- "Q. What if you wanted an assurance on them from a reporting perspective that's the company wanted assurance on them for a reporting perspective?
- A. Well if the –
- Q. Can the audit committee then be the right place to go?
- A. No, I say if the company wanted advice upon that reporting it would look to external advisers rather than to the audit committee."

[136] In the context of an exchange about debt classification, it was suggested to Mr Hullah that it was the responsibility of the audit committee members (rather than the company's management) to raise specific issues with Ernst & Young which may have financial reporting consequences. Mr Hullah rejected that and again explained the different functions and roles of the audit committee, management, and the external auditors:

- "Q. And you'd expect that audit committee to draw matters to the attention of an auditor if they were believed to be at issue or in issue for reporting in that period, wouldn't you?
- A. No I would expect that it would have been dealt with by the auditor with the executive and I would expect that the audit committee would believe that all the information had been made available that needed to be made available to the auditor, that matters such as classification of debt, proper application of accounting standards and the detail of accounting standards had been discussed at a management level between the auditor and management and therefore when it came to the audit committee it would be an unusual situation where the audit committee would be querying and believing that they knew something which management and the auditors didn't know about debt classification."

[137] This does not mean that the directors are abdicating their responsibilities. Rather, they are fulfilling their responsibilities by employing a qualified finance department and expert external auditors as part of a process intended and reasonably

expected to ensure that the financial statements are compliant. The point is again illustrated in an exchange from Mr Hullah's evidence in the context of the financial reporting implications of the ANZ debt:

“THE COURT:

- Q. Can I just ask a question arising out of that? If I've understood your evidence in chief correctly you say it was the responsibility of Ernst & Young of Mr Painter to bring that to the attention of the audit committee as a member of the audit committee?
- A. I have said in my evidence that it was a responsibility that through their engagement to advise on the IFRS standards and then as the reviewers, they should have become aware of it and then they should have brought it to the attention of the audit committee yes.”

And further on he said:

“I am saying that the company and therefore the directors specifically engaged a major firm of accountants who had claimed understanding of IFRS requirements. They engage them to provide the advice because as was common with all companies at that stage it was known to be a very complex and intensive issue therefore you employed external advisers to advise you, to assist you and in my view the preparation of the financial statements is a co-operative to a certain extent, it doesn't happen in isolation. And management when it's preparing the financial statements would be regularly consulting with its auditors to make sure that they were going to be comfortable with those financial statements when they were issued. And they would be consulting with them on accounting standards and they'd specifically expect that in this circumstance Ernst & Young would have that detailed knowledge so I think that puts it in the context.”

[138] I agree with Mr Hullah's evidence. That said - again the directors acted in good faith, made the appropriate inquiries as indicated by the circumstances and had no knowledge that such reliance was unwarranted. They cannot be held responsible for Ernst & Young's failure to identify the appropriate debt classification or to give advice that the breach of covenants needed to be disclosed.

**Messrs Thomas and Feeney relied on the recommendation of the audit committee**

[139] The directors Thomas and Feeney were not members of the audit committee. It is only CA 93 s 138 which requires this differentiation between these and the other directors (s 138(1)(a)). These two directors had the additional entitlement to rely on the audit committee. Their reliance on the audit committee satisfied the requirements of s 138(2). But in this case it is really an unnecessary gloss because

the other steps which I have described were already sufficient to establish the s 40 defence.

**ADDITIONAL STEPS THE INFORMANT SUBMITS THE DIRECTORS SHOULD HAVE TAKEN**

[140] In his closing address counsel for the informant set out reasonable steps that should have been taken by the directors in addition to those they did take. These steps are as follows - that the directors should have:

- (1) looked at the standards themselves;
- (2) asked of Ernst & Young if the classification of the ANZ facility was correct or not;
- (3) asked Ernst & Young for an opinion on the impact of the ANZ facility on the financial reporting requirements;
- (4) ensured Feltex's financial management team knew how to properly deal with the implications of the ANZ facility on the reporting requirements;
- (5) asked management for an opinion on the impact of the ANZ facility and the reporting requirements;
- (6) known to report the breach of covenants within the facility;
- (7) asked ANZ for a written waiver in anticipation of the breach of covenants as at balance date;
- (8) ensured that Ernst & Young had all the relevant documents and information to perform the review;
- (9) and, in the case of Feeney, Thomas, Saunders and Hunter, asked Mr Hagen to interpret the standards.

**Fundamental Question:**

**Did the directors have to do it themselves? Were the directors:**

- **themselves required to engage in a study of the accounting standards and the way they applied to Feltex?**
- **themselves required to engage in a study of the interim financial statement to satisfy themselves that the statement complied with the standards?**

[141] Before I consider seriatim the additional steps the informant submits the directors should have taken it is necessary to focus on a more general proposition inherent in the submissions of counsel for the informant. In the main the suggested additional steps resolve into an argument that the directors should themselves have engaged in a study of the accounting standards, of the way in which they applied to Feltex and the interim financial statement, and of whether in their own individual judgments the statement complied.

[142] This approach necessarily resolves further into an argument that the directors should personally have had the requisite qualifications, expertise and experience to analyse the financial statement from the perspective of the accounting standards and to have reached a conclusion about compliance based on their own judgment. In other words, that they were not entitled to rely on professional expert advice and had to do it themselves.

[143] This argument is refuted by my finding that as a matter of law the directors are entitled to the benefit of s 138 of CA 93 and that they did take appropriate steps to obtain advice upon which they relied as they were entitled to do. When the proposition that the directors “should have done it themselves” is tested by analysing the way in which the directors would need to have equipped themselves and what they would need to have done it can be seen why the common law developed the principle codified by s 138, that directors are entitled to rely on advice where appropriate conditions are satisfied. It can be seen that the “they should have done it themselves” proposition is utterly unrealistic. It also demonstrates why reliance on advice, where appropriate conditions are satisfied, does not detract from, but enhances, the quality of directors’ duties.

[144] It is first necessary to understand the nature of the applicable financial reporting standard. Relevant terms are defined in FRA s 2:

“Applicable financial reporting standard, in relation to a reporting entity or a group and to an accounting period or to an interim accounting period of a reporting entity, means an approved financial reporting standard that applies to that reporting entity or to that group and to that accounting period or that interim accounting period in accordance with a determination of the Board for the time being in force or any election made under s 27 of this Act:

Approved financial reporting standard means a financial reporting standard approved by the Board under s [24] of this Act; and includes an amendment to an approved financial reporting standard that is approved by the Board under that section:

...

“Board” means the Accounting Standards Review Board established by this Act.”

[145] The Board was established by s 22 of the FRA. It is a Crown entity for the purposes of s 7 of the Crown Entities Act 2004. Its functions include “To review and, if it thinks fit, approve financial reporting standards submitted to it for approval for the purposes of [the FRA]”, and “to review, and, if it thinks fit, approve amendments to any approved financial reporting standards”. Financial reporting standards are submitted to the Board by the Institute of Chartered Accountants.

“The [Institute of Chartered Accountants of New Zealand] and any other organisation or person may, from time to time, submit –

(a) Financial reporting standards; and

(b) Amendments to any approved financial reporting standards –

to the Board for approval”: FRA s 25

[146] The Financial Reporting Standards Board (FRSB) is a permanent board of the Institute of Chartered Accountants of New Zealand (also called the New Zealand Institute of Chartered Accountants – the Institute). Its objective is to develop and maintain definitive standards and other guidance on all aspects of financial reporting. Amongst other things it submits financial reporting standards to the Accounting Standards Review Board (ASRB) for review and approval.

[147] Scheduled to this judgment is a reproduction of the Institute’s web page referring to New Zealand Equivalents [ie NZIFRS] to International Financial

Reporting Standards – 2010 Volume. [http://www.nzica.com/AM/Template.cfm?Section=New\\_Zealand\\_Equivalents\\_to\\_International\\_IFRS&Template=/CM/ContentDisplay.cfm&ContentID=18525](http://www.nzica.com/AM/Template.cfm?Section=New_Zealand_Equivalents_to_International_IFRS&Template=/CM/ContentDisplay.cfm&ContentID=18525). The standards comprise the material commencing “New Zealand Preface” and concluding “Glossary of Terms (in New Zealand Equivalents to IFRSs)”. It is possible to click on the various standards to obtain the content, but of course you have to know where to look for information in relation to any particular matter. Some material is available only by obtaining hard copy (“the bound volumes of the Applicable Financial Reporting Standards (ie NZ IFRSs)”, as referred to under “Content subject to IASB copyright”).

[148] The size of the material contained in the standards can be judged by the indication of the electronic size of each item. By way of example the New Zealand Preface at the beginning (67 KB) is 18 pages, and the Glossary of Terms at the end (259 KB) is 72 pages.

[149] The financial reporting standards not complied with are NZIAS 34 and NZIAS 1.60 (classification of the ANZ loan) and NZIAS 34 (non-disclosure of the breach of financial covenants). It will be observed from the Institute’s web page that NZIAS 1 follows the Preface and nine NZIFRS standards available via the web page plus the additional material available only in hard copy. NZIAS 34 follows those same items plus the preceding 33 NZIAS standards.

[150] NZIAS 1 is 11 pages. The particular part relied on by the informant is at para 69(d):

**“Current Liabilities**

...

The entity does not have an unconditional right to defer settlement of the liability for at least twelve months after the balance sheet date. ...”

[151] NZIAS 34 is 27 pages. It deals with the disclosure requirements. The particular parts relied on are para 16 which provides for “Selected Explanatory Notes”, and specifically at para 17 which provides an illustrative list of examples and at 17(i) says:

“any loan default or breach of a loan agreement that has not been remedied on or before the balance sheet date.”

[152] These are only two of many thousands of different rules contained within NZIAS. That is an important contextual factor in this case. As summarised in para [6] of this judgment, under the state of affairs as between ANZ and Feltex at the material times the disclosure and classification requirements of IFRS would not have prevailed under the previous standards.

[153] The two relevant differences between IFRS and the previous accounting standards demonstrate a more prescriptive test for the classification of a debt as “current” or “non-current”. All the expert witnesses called agreed this was a fundamental change from the old standards (para 4.6 of FRS-9) which was based on an “expectation” as to whether a liability will be extinguished within 12 months to a new standard (para 60(d) of NZIAS 1) which requires “an unconditional right to defer settlement of the liability for at least 12 months after the balance sheet date”.

[154] There are also under the IFRS standards more prescriptive requirements for disclosure of matters in the explanatory notes to interim financial statements. The old standard (para 5.11 of FRS-24) required disclosures of “relevant matters ... of such incident and size, or of such nature, that their disclosure is necessary to explain the performance, position or cash flows of the entity”. In the state of affairs which existed between Feltex and ANZ at the material time this would not have required disclosure of the breaches. By contrast, the IFRS standard lists specific items required to be disclosed including (para 17 of NZIAS 34) “any loan default or breach of a loan agreement that has not been remedied on or before the balance date”.

[155] When Mr Dickey opened on behalf of the informant, I was surprised that I was shown a large volume containing the standards, briefly passed up to me for perusal, but I was not given it or indeed at that time a copy of the standards relied on by the informant. As they were the foundation for the allegation of non-compliance and of resultant commission of offences by the directors I was somewhat surprised. All I was given in the written opening were brief quotations of a few words. In response to my request for a copy of the relevant standards I was told that extracts were amongst the exhibits which would be produced by an expert witness in due course.

[156] These observations are not to be taken as critical of the informant's counsel. It is not surprising that relevant provisions needed to be introduced to the Court by an expert because they are complex, and are written for persons with an understanding of accounting principles, an understanding not available to someone lacking appropriate training or experience. They were introduced by a witness for the informant, Mr Prichard.

[157] In addition, the new standards represented a "sea change" from GAAP. GAAP's longevity had at least given professional directors the opportunity of becoming familiar with them. NZIFRS standards are much longer, more complicated and more prescriptive than those which applied previously as appears from earlier discussion.

[158] As a result of the expert evidence it became apparent to the Court that the standards are an arcane set of prescriptions. The magnitude of the task of converting to IFRS is demonstrated by the fact that even experts in the accounting field required intensive and ongoing training in order to be able to apply the standards and advise their clients. Both Messrs Prichard and Painter spoke of the training programmes conducted within their respective organisations. Their evidence demonstrated it would have been insufficient even for an auditor to simply go away and read the new standards from cover to cover. Rather it was necessary for them to attend courses on the new standards and then to complete further educational programmes on a continuing basis in order to be able to adequately advise on and apply IFRS. Even then the auditor would be able to have recourse to a technical director, a member of the firm with even more specialised familiarity with the standards.

[159] Mr Hagen also addressed this issue in response to a question put to him in cross-examination suggesting that investors would expect directors to know the IFRS rules relating to the classification of liabilities:

"... the director's responsibility is to do with governance of a company, a director's responsibility is not to prepare the financial statements themselves, it is to ensure that those who are preparing them are properly and adequately qualified and capable and that those who review them are properly qualified and able. I would not expect any director to do a detailed review of a set of financial statements. As I have said before, there are in current IFRS there are more than 3000 disclosure requirements, now I wouldn't be capable of

doing that. The only people who are capable of reviewing a set of financial statements are those who have the detailed knowledge to prepare them such as Lynn Ruddell, the chief financial, the chief accountant, the auditors who do this sort of thing routinely or maybe a technical partner at one of the major accounting firms. Those are the three categories of people who I would expect to have sufficient knowledge to be able to pick up what would be a very thick booklet of checklists and go through them and understand them. I would not expect anybody else to be able to do that review. They just would not have the technical knowledge.”

[160] The complexities of a transition to IFRS were identified in the Ernst & Young engagement letter dated 20 June 2004 in which it is stated:

“As we have discussed, converting your financial accounting and reporting systems to conform with IFRS requires a tremendous commitment of management’s time and energy. Further converting to IFRS necessarily means that there are a number of significantly different financial accounting and disclosure requirements that will result in important financial statement differences.”

[161] Although the words of individual IFRS paragraphs may be easily understood they form part of a complicated and technical regime of interconnecting standards. As already averted to, the major chartered accounting firms at least have their own technical departments to assist their audit departments to understand and apply these rules.

[162] For someone without that expertise it is not always possible even to find the relevant rule. For example, the “scope” section of NZIAS 1 provides in para 3 that the standard “does not apply to ... interim financial statements prepared in accordance with NZIAS 34”. Mr Prichard gave evidence which relied on a combination of para 5 of NZIAS 8 and paras 10, 28, 41 and appendix C of NZIAS 34 to conclude that, notwithstanding the apparently plain meaning of para 3 of NZIAS 1 it does in fact apply to interim financial statements. His conclusion on that issue was not disputed but the interpretation which leads to the conclusion must be noted to be neither straightforward nor obvious to someone without his level of expertise.

[163] Having made those general observations I now turn to the additional steps identified by counsel for the informant.

## **Specific steps advanced by informant**

### They themselves should have looked at the standards

[164] This submission overlooks the reality of the complicated and highly technical regime represented by these standards and the highly specialised expertise needed to interpret them. Refer paras [62] to [67] inclusive, and [141] to [162] inclusive.

### They should have specifically asked of Ernst & Young if the classification of the ANZ facility was correct or not

[165] The directors did do this implicitly in a number of ways. First, they engaged Ernst & Young to prepare an IFRS assessment report to specifically identify the differences in reporting as a result of IFRS. It goes without saying that this will include something as important as “classification” of the facility. Secondly, they ensured that all relevant documentation was provided by Feltex management to Ernst & Young, including the fourth restatement. Thirdly, they employed Ernst & Young to supervise management’s preparation of the financial statements. Fourthly, they employed Ernst & Young to review the accounts. Fifthly, Mr Thomas, the CEO, expressly asked Mr Painter if the statements complied in all respects with IFRS (which must also include correct classification of the ANZ facility).

### They should have asked Ernst & Young for an opinion on the impact of the ANZ facility on the financial reporting requirements

[166] This does not appear to be materially different from the second submission. In any event I am satisfied that in calling for the IFRS assessment report and engaging Ernst & Young to conduct a review of the half yearly accounts, such an opinion was an implicit part of those processes and they would reasonably have expected to receive such an opinion. They did, but it was wrong.

### They should have ensured Feltex’s financial management team knew how to properly deal with the implications of the ANZ facility on the reporting requirements

[167] I am satisfied they did do this by establishing a comprehensive transition process from GAAP to IFRS and by creating and establishing a steering committee comprising Feltex’s financial management team to be supervised by the experts

Ernst & Young who were to actively advise, educate, assist and participate in the review of all of the IFRS standards applicable to Feltex. In addition they also engaged Ernst & Young to review the statements. Had Ernst & Young properly supervised Feltex's financial management, and had they conducted the review to the appropriate requisite standard, the implications of the ANZ facility and the reporting requirements would have been properly understood by management and the statement prepared differently so as to comply with the standard.

They should have asked management for an opinion on the impact of the ANZ facility and the reporting requirements

[168] I see no material difference between this step and the submission dealt with in the previous paragraph. The processes the directors put in place ought to have yielded the correct opinion. They did not – not through any fault of the directors but rather through the erroneous approach taken by their specialist advisers. There was nothing to put the directors on notice of their specialist advisers' errors for the reasons explained earlier in the judgment.

They should have known to report the breach of covenants within the facility

[169] I have dealt with this issue at paras [58] to [67] inclusive.

They could and should have asked ANZ for a written waiver in anticipation of the breach of covenants as at balance date

[170] I have dealt with this issue at paras [71] to [76] and I return to it below at [184] to [197]. In short, the directors were not advised correctly by Ernst & Young and had they been this may have been a course they chose to adopt. It may not – they may have sought to deal with it solely by way of explanatory note to the statements.

They should have ensured that Ernst & Young had all the relevant documents and information to perform the review

[171] I am satisfied that the directors did put in place processes which did ensure all relevant documents and information were made available to Ernst & Young. All the evidence establishes that Feltex management were fully co-operative with their

specialist advisers Ernst & Young, and that Ernst & Young did in fact have all the necessary information and documentation to properly perform the review. The fact that they did not conduct the review properly is through no fault of the directors or management withholding information or documentation from Ernst & Young.

Messrs Feeney, Thomas, Saunders and Hunter should have asked Mr Hagen to interpret the standards

[172] It would be easy to get the impression that Mr Hagen was in a different position to other directors because he previously practised as a chartered accountant (though not as an auditor), was chairman of Deloitte, and had been chairman of the Accounting Standards Review Board.

[173] Mr Hagen was not brought onto the Board of Feltex to prepare or audit the company's accounts. Feltex already had a finance department and Ernst & Young to fulfil those functions. Mr Hagen was appointed for his business and management experience and to fulfil the normal duties of a director. The argument that a retired accountant on a company's board is expected to prepare or audit the company's accounts indicates a failure to appreciate the proper role of a company director. It is akin to saying that a lawyer on a company's board should be responsible for the company's conveyancing work.

[174] Moreover, Mr Hagen did not practise as an auditor – other than very briefly at the start of his career over 40 years ago, and did not have a detailed knowledge of financial reporting standards. His practice in the areas of valuation and corporate finance had nothing to do with financial reporting standards. He had been involved at a policy level in the approval of pre-IFRS financial reporting standards, but that only gave him general knowledge of the (very different) pre-IFRS standards. Mr Hagen explained that none of his prior practising experience gave him a detailed knowledge of financial reporting standards, and certainly not of the new IFRS standards. For example, in response to a question in cross-examination suggesting that accountants should know financial reporting standards, Mr Hagen said:

There would be very few accountants who would read financial [reporting] standards, you seem to think that all accountants do is read financial reporting standards, that is not true. In Deloitte you've got a secretarial

section which prepares financial statements; they would have a broad knowledge of financial statements. You'd have an auditing section who would know because they have got check lists and yeah, a continuing education programme would ensure they knew about accounting standards. You have the tax section which would not know what an accounting standard was, you have the corporate financier where I was who had no application for financial reporting standards, you've got the general consulting division which wouldn't know what an accounting standard was so knowledge, as I have said before, knowledge of accounting standards in the detail that you would be required to do this review or say whether a set of financial statements complied with it or not would be restricted to the accountants who for a living prepared financial reporting standards, auditors who for a living reviewed financial reports and technical directors who advised, gave advice to the audit section of an accountancy firm. Those three are the only three categories who in my opinion would be expected to know what's in an accounting standard.

[175] It was also suggested in cross-examination of other directors that Mr Hagen was chairman of the ASRB when it oversaw the introduction of the IFRS standards in New Zealand. That is incorrect. Mr Hagen retired as chairman of the ASRB on 16 February 2003. In December 2002 (shortly before Mr Hagen's retirement), the ASRB had announced the proposed adoption of IFRS commencing 1 January 2007, but it had not by that stage started the process of considering and approving IFRS standards. That process was undertaken by the ASRB in 2004 and 2005. The standards in question in this case – NZIAS 1, 32 AND 34 – were all approved by the ASRB in November 2004, some 21 months after Mr Hagen's involvement with the ASRB ceased. Mr Hagen had no involvement in the adoption of those standards and no detailed knowledge of them.

### **ERNST & YOUNG'S FAILURES**

[176] This case is not about Ernst & Young's responsibilities but about these directors' responsibilities as directors and how they discharged their responsibilities.

[177] It is, however, necessary for me to make some comments on Ernst & Young and how they discharged their responsibilities, but only as it interfaces with the directors discharging their responsibilities.

[178] Although implicitly invited to do so in the submissions for the directors, I find it is not necessary for me to examine and make findings about what went wrong

internally within Ernst & Young that led to their failure to adequately advise the directors. They did fail but a minute examination of their internal procedures to attempt, or to apportion blame within their ranks is irrelevant to the interface between the directors' responsibilities and whether or not they discharged them properly in respect of the FRA.

[179] While Mr Painter had the ultimate responsibility on behalf of Ernst & Young, the bulk of the work done for Feltex was done by Ms Herman or under her direction. I resist making findings about what she and her team did because I have not heard from those who are alleged to have made those mistakes, other than Mr Painter himself.

[180] It is important to note that Ernst & Young's IFRS assessment report was completely wrong when it stated in relation to the classification of liabilities, that the amendments to the standards "represented a change in terminology only" and that there were "no implications" for Feltex in terms of complying with the standards in this respect.

[181] Far from being simply a change to the terminology to be applied in the accounts, the terminology in fact remained the same while the underlying definitions of current and non-current liabilities underwent a fundamental change in approach. I have described the differences in para [85].

[182] The steering committee paper which addressed amongst other things the issue of debt classification was prepared on 23 February 2005 by Ms Lynn Ruddell, Feltex's group financial controller. The paper purports to contain a summary of the new IFRS requirements under IAS-1. It is now apparent that the summary is deficient in at least one regard, in that it fails to identify the need for an "unconditional right to defer" in order for a debt to be classified as non-current. The absence of such an explanation was not identified during the supervision of Feltex's financial management department being carried out on a standard by standard basis by Ernst & Young.

[183] That summary would have had the effect of reinforcing in the minds of the members of management and the audit committee the comments in relation to this requirement in the Ernst & Young IFRS assessment report that there was nothing to indicate there was any fundamental change in approach with regard to this standard.

[184] The evidence is clear that, at the time of conducting its review of the 31 December 2005 financial statement Ernst & Young knew:

- (a) Feltex had entered into a new facility agreement with ANZ in October 2005. Mr Painter confirmed his personal knowledge of this and it is also apparent from the Ernst & Young work papers.
- (b) Feltex was in breach of the debt cover and interest cover covenants in the facility agreement as at 31 December 2005. In a letter written to the Securities Commission on 6 September 2006, Ernst & Young confirmed that at the time of conducting the review “we had been informed that Feltex was in non-monetary breach of its loan covenants with ANZ Bank”. That is consistent with Mr Painter’s evidence.
- (c) A breach of covenant was an event of default under the facility agreement. This was apparent from the (unchanged) terms of the prior facility agreement and is also a standard consequence of a covenant breach.

[185] If they were correctly applying the new NZIFRS standards those matters known to Ernst & Young demanded further inquiry from Ernst & Young so that it could satisfy itself that the covenant breach had been waived by the bank such that the debt could properly be classified as non-current in accordance with paras 60(d) and 65 of NZIAS 1.

[186] But Ernst & Young and Mr Painter made none of the obvious inquiries. Specifically Mr Painter acknowledged that he had never even asked Mr Tolan or anyone else at Feltex whether the breach had been waived. He acknowledged that he had neither asked for nor received written evidence of a waiver, nor did he assume that such a letter even existed. He accepted that asking for a written confirmation of

waiver would have been a sensible thing to do. No-one at Ernst & Young took the step of speaking to the bank to clarify the status of the covenant breach. Mr Hullah says they should have.

[187] Mr Painter said that he never looked at the fourth restatement of the ANZ facility agreement but acknowledged that it would have been made available to him had he asked for it. I am satisfied that despite his evidence to the contrary the fourth restatement of the ANZ facility agreement was provided to Ernst & Young by Feltex.

[188] Mr Painter failed to raise the issue of the covenant breach at the audit committee meeting on 16 February 2006 and he failed to even discuss the issue of the covenant breach with his own staff to ensure that they were aware of the issue and its potential implications for the review.

[189] The expert evidence of both Mr Prichard and Mr Hullah confirms the reviewer should have made further inquiries in the circumstances to obtain proper evidence that the covenant had been waived and accordingly that the debt classification was correct.

[190] Mr Prichard acknowledged that, with a company in Feltex's position at the time, an auditor should have paid "particular attention to the classification of that company's debt in the performance of [a review engagement]". He also said that had he been aware of a breach of a banking covenant when conducting a review he would have raised that expressly with the audit committee.

[191] Mr Hullah's expert evidence was:

"In my opinion, it was not sufficient and not in accordance with either RS-1 or RG-1, which both require a judgment regarding the extension of normal review procedures to be applied in circumstances such as these, for the reviewer to rely on management's views that the relationship with ANZ was "good", there was "no evidence of no support from ANZ" and there was "no evidence of ANZ seeking to renegotiate the debt". There was evidence of a debt restatement, Ernst & Young knew that a banking covenant had been breached, and it had not seen positive evidence of ANZ waiving its rights under the breach. Ernst & Young should have appreciated that the breach gave ANZ the right to renegotiate the maturity of the debt such that it would become a current liability. It should have realised that this would have a

material effect upon the truth and fairness of the interim financial standards for the half year ended 31 December.”

[192] In response to evidence given by Mr Painter, Mr Hullah confirmed his opinion that the steps taken by Ernst & Young were inadequate. Having been alerted to the fact of the covenant breach Ernst & Young were obliged to request and see a documented waiver from the bank. Mr Hullah further said that having been made aware of the covenant breach Ernst & Young were obliged to carry out inquiries on that issue in the nature of an audit. He rejected the proposition that any competent reviewer could decide not to make further inquiries in those circumstances. It was Ernst & Young’s responsibility to ask for the relevant documents. They could not wait to be provided with the relevant documents. He was clear that it is not the duty of the audit committee to bring relevant facts to the reviewer’s attention. The audit committee would expect the reviewer to know the relevant facts. In the circumstances of this case Ernst & Young should have made inquiries directly of the ANZ Bank.

[193] I have already held that Ernst & Young did receive the fourth restatement. I am satisfied they failed to review it or understand its terms, or understand the implications as far as the reporting standards were concerned.

[194] While Mr Painter disputed the level of assurance that the directors could legitimately take from the review engagement, I find that had the review been undertaken competently and thoroughly it would have identified the issues currently before the Court and the directors would have received advice accordingly.

[195] Having engaged Ernst & Young to act as the company’s IFRS advisers the directors could legitimately expect that the review would pay particular attention to ensuring that the IFRS requirements were met. Their expectation is illustrated by the questions that were asked at the audit committee meeting of 16 February 2006 by both Mr Thomas and Mr Hagen. While Mr Painter stated in evidence that he would not have used the word “assurance” in response to Mr Thomas’s question, he did not deny that the question had been asked, or that he had provided an affirmative response. Had Ernst & Young had concerns as to the compliance with IFRS it would have been incumbent on them to make sufficient inquiries to satisfy

themselves that the requirement had been met or to raise any concerns they held with the audit committee. The review's express purpose of restoring Feltex's credibility in the market as recommended by Ernst & Young, and in the context of Feltex preparing its first IFRS-based accounts, reinforced the directors' legitimate expectations and their entitlement.

[196] The directors' concerns with compliance were allayed by the responses received. Mr Hullah reviewed the relevant documents from Ernst & Young filed on the review and concluded that they failed to perform the review engagement to a proper professional standard in that it failed to "perform a proper review assessment", failed to "extend its review procedures to seek adequate external confirmation of the status of the ANZ Bank debt", failed to "identify the need to classify the ANZ Bank debt as a current liability", and failed to "identify the need to refer to the breaches of bank covenants in the explanatory notes to the interim financial statements".

[197] If Ernst & Young had performed the review to a proper professional standard as the directors were entitled to expect they would have identified and advised Feltex and the directors of the need to classify the bank debt as a current liability and to refer to the covenant breach in the explanatory notes. Mr Hullah set out in his evidence the type of report and advice which Ernst & Young should have provided. If the directors had received that advice there is no doubt that they would have required Mr Tolan to amend the financial statements to ensure compliance with IFRS.

## **CONCLUSION**

[198] For the reasons given in this judgment I find each of the directors not guilty of the two charges laid.

J M Doogue  
District Court Judge

## SCHEDULE



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- [New Zealand Equivalents to International Financial Reporting Standards](#)

### **New Zealand Equivalents to International Financial Reporting Standards - 2010 Volume**

Certain small entities are permitted to continue applying New Zealand FRSs and SSAPs, and are not required to adopt New Zealand equivalents to International Financial Reporting Standards (NZ IFRSs), for annual accounting periods commencing on or after 1 January 2007. The criteria which these entities are required to meet are detailed in [ASRB Release 9](#) Delay of the Mandatory Adoption of New Zealand Equivalents to International Financial Reporting Standards for Certain Small Entities. Also see the [Amendments to the New Zealand Preface](#).

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- [NZ Preface](#) (67KB)

#### **New Zealand Framework**

- [New Zealand Equivalent to the IASB Framework for the Preparation and Presentation of Financial Statements](#) (**Available only in hardcopy in the 2010 bound Volume of NZ IFRSs**)

#### **Differential Reporting**

- [Framework](#) for Differential Reporting under NZ IFRSs (171KB)

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