

## **THE DESCRIPTION OF THE RESPONSIBILITIES OF THOSE CHARGED WITH GOVERNANCE**

### **Explanation of Decisions made by the NZAuASB in Finalising the amendments to the ISAs (NZ) to describe the responsibilities of those charged with governance**

**Issued September 2015**

This document relates to, but does not form part of the International Standards on Auditing (New Zealand) that have been amended as a result of changes to the Companies Act 1993 and Financial Markets Conduct Act 2013. The amendments were approved by the NZAuASB in September 2015. This document summarises the decisions of the NZAuASB in finalising the amendments proposed by Exposure draft 2015-2 *Proposed Amendments to the ISAs (NZ) to Describe the Responsibilities of Those Charged with Governance*.

This document is an explanatory document and has no legal status.

## **COPYRIGHT**

© External Reporting Board (“XRB”) 2015

This XRB Explanatory Document contains copyright material.

Reproduction in unaltered form (retaining this notice) is permitted for personal and non-commercial use subject to the inclusion of an acknowledgement of the source.

Requests and enquiries concerning reproduction and rights for commercial purposes within New Zealand should be addressed to the Chief Executive, External Reporting Board at the following email address: [enquiries@xrb.govt.nz](mailto:enquiries@xrb.govt.nz)

ISBN 978-1-927292-93-8

**THE DESCRIPTION OF THE RESPONSIBILITIES OF THOSE CHARGED WITH GOVERNANCE**

**Explanation of Decisions made by the NZAuASB in Finalising the amendments to the ISAs (NZ) to describe the responsibilities of those charged with governance**

**CONTENTS**

---

	Paragraph
<b>BACKGROUND .....</b>	1-2
<b>MAJOR ISSUES RAISED BY RESPONDENTS ON EXPOSURE .....</b>	3
<b>RATIONALE FOR AMENDMENTS MADE TO THE INTERNATIONAL STANDARDS .....</b>	4-15

## **BACKGROUND**

1. New Zealand's financial reporting regime has recently been amended following the enactment of the Financial Reporting Act 2013 (and the associated amendments to other Acts providing financial reporting obligations). The effect of the amendments has been to shift the statutory (and direct legal) responsibility for ensuring that financial statements are prepared from the directors (or those charged with governance) of an entity (as was the case under the Financial Reporting Act 1993) to the entity itself.
2. The NZAuASB issued an exposure draft ED 2015-2 proposing limited amendments to the ISAs (NZ) as a result of these changes. The exposure draft was issued on 30 June 2015, with a comment deadline of 14 August 2015.

## **MAJOR ISSUES RAISED BY RESPONDENTS ON EXPOSURE**

3. Six submissions were received from practitioners, a professional body, the Institute of Directors and a lawyer. The feedback received was largely supportive of the proposed amendments however one submitter recommended more extensive changes to the international standards and the New Zealand explanatory paragraph than had been exposed. The NZAuASB finalised the amending standard as proposed. Changes that impact on the auditor reporting package, also approved by the NZAuASB in September have been included in the revised standards.

## **RATIONALE FOR AMENDMENTS MADE TO THE INTERNATIONAL STANDARDS**

### *Impact of legislative change*

4. The statutory (and direct legal) responsibility for ensuring financial statements are prepared has shifted from the directors to the company or FMC Reporting Entity (as applicable). The NZAuASB has considered the effect of the changes to New Zealand's financial reporting legislative regime on the ISAs (NZ) and is of the view that the directors (or those charged with governance) continue to have responsibility (albeit not as a matter of express legal duty relating to the approval of financial statements) for ensuring that compliant financial statements are prepared in respect of an entity.
5. This view is supported by the provisions of the Companies Act and commentary, for example:
  - a. Section 128 of the Companies Act provides that the business and affairs of a company must be managed by, or under the supervision of, the board of directors of a company. The preparation of financial statements for a company would fall within the "affairs of the company" that must be managed by or under the supervision of the board (if financial statements had to be prepared in respect of the company).

- b. In addition, directors are subject to a number of duties under the Companies Act, including the duty (under section 134) not to act, or agree to the company acting, in a manner that contravenes the Act or the constitution of the company. If financial statements for a company were not prepared in accordance with the requirements of the Act, the directors of the company may have breached their duty under section 134.
- c. Farrar and Watson in *Company and Securities Law in New Zealand*, states at 9.8 (when referring to the decision of Lord Hoffman in *Meridian Global Funds Management Asia Limited v Securities Commission* [1995] 3 NZLR 7 (Privy Council)) that:

“[i]n common with other business organisations, as an artificial legal construct, there is no such thing as a company as such. It must be the human beings involved with a company who deal with others on behalf of the company.”

6. Consequently, where a company is required by law to do something, the individuals in the company who have the power or authority to do that thing for or in the name of the company are the persons who, in effect, are responsible for ensuring that the thing is done by doing it themselves, acting for that purpose as the company, because a company cannot act by itself. In the case of the statutory requirement of a company to ensure that financial statements are prepared in relation to it, this obligation would ordinarily be performed by the directors, or by management under the supervision of the directors, acting in either case as the company, as contemplated by (and required under) section 128 of the Companies Act. Importantly, it is the board of a company that ultimately considers, approves and adopts the financial statements for the company.
7. The view that directors remain responsible in practice for ensuring that financial statements are prepared in relation to a company is also supported by the liability regime for breaches of the financial reporting provisions in both the Companies Act and FMCA.
8. The structure of the liability for breaches of financial reporting obligations, together with the common law and statutory position on the responsibility of directors to manage the affairs of a company and the artificial nature of a company all support the view that directors remain responsible in practice (and at law by virtue of the criminal offence regime in the Companies Act and the FMCA) for ensuring that a company’s financial statements are prepared in accordance with the applicable statutory requirements, despite the recent legislative changes made in New Zealand.

All of the submissions received were consistent with the Board’s understanding of the New Zealand legislative requirements, and the Board considered that the views expressed did not raise any new issues or information that would trigger further compelling reason changes to be made.

### *Amendments required*

9. The NZAuASB identified that the contextual paragraph added to a number of ISAs (NZ) required modification as a result of the legislative change that shifted the statutory (and direct legal) responsibility for ensuring financial statements are prepared from the directors to the company or FMC Reporting Entity (as applicable). The current wording of the paragraph, therefore, does not accurately reflect the position in New Zealand. The amendments are necessary to clarify and to be consistent with the legal context in New Zealand in relation to responsibility for ensuring financial statements are prepared for an entity, while simultaneously acknowledging the premise on which an audit is undertaken as established by the international auditing standards. The Board agreed to make the limited amendments as proposed in order to ensure the internationally-based standards are consistent with the New Zealand legal position, and determined that further guidance should not be added as the Board is of the view that it is not the role of the auditing standards to explain New Zealand legal requirements in relation to the internationally-based wording.

### *Illustrative examples including the engagement letter, representation letter and auditor's report*

10. The NZAuASB had received indications that the existing wording in engagement letters, representation letters and auditor reports, based on the illustrative examples in the standards, are tending to be the subject of debate and dispute. The Board received submissions indicating that this is adding time and cost to the audit process. While the existing wording referring to the responsibility of the directors for the preparation of the financial statements appropriately reflects their responsibility in practice, the NZAuASB considered that it would be helpful to clarify these statements following the legislative amendments. However, any additions to the international illustrations should be kept to a minimum, consistent with the NZAuASB's strategy of adopting the international standards in New Zealand. For this reason the NZAuASB did not agree to add any additional wording to the illustrations, as the NZAuASB is of the view that it is not the role of the auditing standards, or the role of the engagement letter, representation letter or auditor's report to explain the legal responsibilities of the directors in New Zealand.
11. The NZAuASB has amended the illustrative engagement letter, representation letter and auditor reports by adding the words "on behalf of the entity". The NZAuASB considers it necessary to make this limited change to the illustrative engagement letter because the letter is used as a contractual document, and it would be useful to remove the potential for the auditor's interpretation of the use of the word "responsibility" in establishing the contractual terms to be misunderstood. The engagement letter is intended to make it clear (as between the auditor on the one hand and those charged

with governance and management on the other) who is responsible for what in the process of preparing the financial statements and more generally to set out the terms on which the audit is being performed.

12. Similarly, it is necessary to clarify the meaning of the term “responsibility” in the representation letter that the auditor will request from those charged with governance, to be consistent with the contractual terms set out in the engagement letter.
13. It is further necessary to clarify the responsibility of those charged with governance in the illustrative auditor’s report, as this is the output of the audit and should therefore also consistently reflect the terms upon which the audit was performed. The clarification may also reduce any risk that a user may imply from the wording of the auditor’s report that those charged with governance are under a legal duty (as opposed to being responsible in a practical sense) to prepare the financial statements.
14. The terms of the engagement, the representation letter and the auditor’s report all consistently refer to the responsibilities of those charged with governance and therefore if amended, should all be amended consistently. Modifying the international illustrations by clarifying that those charged with governance are acting “on behalf of the entity” meets the compelling reason test. The addition of those words better reflects the legislative position in New Zealand without detracting from the premise upon which an audit is conducted. In practice, the NZAuASB accepts that referring simply to the “responsibilities” of those charged with governance may lead to unnecessary cost and time being spent to reach agreement on the engagement, in cases where directors note that the entity itself is responsible in statutory terms for preparing the financial statements.
15. The NZAuASB considered but agreed not to amend the requirements of the ISAs (NZ). This would result in pervasive changes to the ISAs (NZ). The NZAuASB understands that the New Zealand legislative requirements are not materially different from other jurisdictions which apply the international requirements. The NZAuASB’s approach is to adopt the international standards in New Zealand unless there are compelling reasons to modify them. The NZAuASB does not consider that there are compelling reasons to make pervasive changes to the ISAs (NZ), as the requirements are appropriate in New Zealand. Modifications to the illustrative reports are considered to be sufficient.