

# Directors' Handbook

The New Zealand working guide



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# Directors' Handbook

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by John Shewan, Chairman, PricewaterhouseCoopers

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## Foreword

The aim of this handbook is to focus directors' attention on how they can perform their duties in accordance with New Zealand law, professional standards and other obligations. This is best achieved by directors asking questions about both themselves and the role and activities they perform, or intend to play, in their companies.

This is the fifth edition of this handbook that PricewaterhouseCoopers has produced. This year, we have included legislative changes that have recently occurred and we have extended the scope to include further guidance for audit committees.

Audit committees are critical to effective corporate governance. The market focus is on those companies that conform as well as those that have chosen to follow best practice and strengthen their organisations in this area.

Management, Boards of Directors and audit committees are far more involved in determining and reviewing whether internal controls are appropriate to achieve companies' operating, financial reporting, and compliance objectives.

We trust this handbook will be useful to all directors, both those who are experienced and those new to the role.



John Shewan  
Chairman  
PricewaterhouseCoopers  
June 2008



# 1 Becoming a Director

## Definition of a director

The definition of a director included in Section 126(1) (a) of the Companies Act 1993 is: “a person occupying the position of director of the company by whatever name called.”

The term includes individuals who:

- are required to instruct, or are accustomed to instructing, the Board or an individual director on how to act;
- exercise powers normally reserved for the Board of Directors; or
- exercise powers or duties delegated by, or with the consent of, the Board.

In particular circumstances, individuals can be defined as “*deemed directors*” when they are:

- shareholders actively taking a role in running the business or in the decision-making process;
- company executives;
- employees who have been delegated duties or powers by the Board; or
- consultants and advisers (unless acting in a professional capacity only).

A director for the purposes of the Income Tax Act 2004 has the same wide meaning as in the Companies Act 1993. In some cases the Income Tax Act 2004 treats certain entities as corporate equivalents. For example, unit trusts are treated as companies and as a consequence, the trustees of those trusts are regarded as director equivalents for tax purposes.

Ultimately, it is your actions rather than your title that determine whether you are considered a director in a court of law.

The Institute of Directors’ Code of Practice for Directors and the Corporate Governance in New Zealand, Principles and Guidelines, distinguish between *executive* and *non-executive directors*.

## • Executive directors

Executive directors have a dual role as employees and as directors. As directors they must retain a degree of independence from their executive positions. They will also have responsibilities additional to their executive positions. Executive directors should be appointed as individuals, not because of any positions they hold. They must always be alert to the potential for conflicts between their management interests and the fiduciary duties of a director.

## • Non-executive directors

The main role of non-executive directors is to provide independent judgement, outside experience and objectivity on all issues which come before the Board. Non-executive directors should acquire and maintain a sufficiently detailed knowledge of the company’s business activities and ongoing performance to enable them to make informed decisions. They should also recognise the division between the Board and management and not become involved in management issues or in managing the implementation of Board policy.

## • Trust boards and trustees

This publication is primarily intended for directors of companies in New Zealand. However, it is also considered to be an appropriate guide for trustees in addition to their specific responsibilities under their particular trust deeds and/or constitutions and the provisions of the Trustee Act 1956.

## Before accepting a formal appointment

While there are many reasons for accepting a directorship, there are a number of important questions and issues that first need to be addressed. These include an assessment of the director's ability to fulfil the duties that the position entails, their knowledge of the company's Board and management, and an assessment of the company's activities.

Before accepting formal appointment, we strongly recommend that the following questions be considered. If your response to any of the questions raises a concern, it does not mean the position should be rejected out of hand. Responses to the full range of questions should be carefully considered before accepting appointment.

### Company's activities

- Do you have full knowledge of the ownership and the control of the company?
- Does it use any complex financial instruments or have any off balance sheet arrangements that could have a significant effect on its performance or financial position?
- Has it been involved in any controversial matters?
- Does it enjoy a good reputation?
- Do its operations cause any pollution or other environmental problems?
- Is it operating profitably and generating positive cash flows from operating activities?
- Does the latest annual report highlight any problems?
- Does the future for the company's products or services look promising?

### Board of Directors

- Is the number of Board members appropriate given the size and nature of the company?  
*NB: The NZX listing rules require a minimum of three directors and a minimum of two directors ordinarily resident in New Zealand.*
- Does the constitution of the company contain any unusual procedural matters in respect of directors' meetings?
- Does the Board have a formal charter that sets out the responsibilities and roles of the Board, including any formal delegations to management?
- Is there an appropriate balance between executive and non-executive (i.e. independent and non-independent) directors?  
*NB: The NZX listing rules require identification of a minimum of two independent directors or, if there are eight or more directors, three or one-third of the total number (rounded down to the nearest whole number) of directors (whichever is the greater). The calibre and number of non-executive directors should be such that their views carry significant weight in the decisions of the Board. It is the view of the Institute of Directors that even small companies would benefit from having a non-executive director with suitable experience and skills on the Board.*

- Are the company's responsibilities distributed appropriately, between directors and management?
- Is there a clearly accepted division of responsibilities at the head of the company to ensure a balance of power, authority and decision-making?
- Are independent views on the Board given full and proper consideration and weight?
- What are the experience, reputation and expertise of the existing directors?
- Does the Chief Executive Officer or Chairman tend to dominate the Board rather than encourage all directors to participate in all the significant decisions?
- Are the Chief Executive Officer and Chairman positions held by the same person?  
*NB: As a general rule, the roles of Chairman and Managing Director or Chief Executive Officer should be kept separate and not held by one person at the same time.*
- Is there a corporate plan with long-term objectives for marketing, production, financing and other key aspects of the company's business? Is the plan reviewed regularly?
- What papers are presented to the Board and does the Board paper timetable allow time for adequate preparation?
- Does the Chairman ensure that matters and documents brought to the Board's attention are sufficient to monitor the company's performance?
- Does the Board have a written code of ethics that sets out expectations for ethical decision-making and personal behaviour?
- Does the company have a properly constituted audit committee, and will you be a member of it?
- Will you have unrestricted access to both management and information?
- Does the Board endorse the Institute of Directors' Code of Practice for Directors and the Corporate Governance in New Zealand, Principles and Guidelines?

## Committees

- Does the company use Board committees such as audit, remuneration and nomination committees?  
*NB: All issuers are required to have an audit committee, and other companies with diverse and widely spread shareholdings are encouraged to do so.*
- Are there terms of reference for Board committees, and are their powers, duties, reporting procedures, membership and duration of office clearly recorded?
- Is the number of committee members appropriate given the size and nature of the company? For issuers, does the audit committee comprise solely of directors of the issuer, have a minimum of three members, have a majority of members who are independent directors and have at least one member with an accounting or financial background?
- Is committee service rotational?
- Are non-executive directors entitled to attend meetings of any Board committee (provided the director is not specifically excluded for reasons of conflicts of interest, even if the director is not an appointed member of the committee)?
- Do executive directors and other employees attend Board committee meetings when requested to do so by the committee?

## Assessment of your own position

- Why do they want you to join the Board?
- Do you feel you can make a valuable contribution and that your opinion will be considered?
- How frequently does the Board meet?
- If you are unable to attend a meeting, can you participate by audio or videoconferencing?
- Will you have time to perform all your duties properly?
- Is your role a new position or are you replacing someone who has left the Board, in which case why did the former director leave?
- Does the position provide you with any actual or potential conflict of interest?
- Is the level of remuneration reasonable in relation to the time required and the risks involved?
- Does the constitution give the company authority to indemnify or insure your liability for action against you by third parties?
- Are you able to obtain adequate indemnity insurance cover?
- Are there any matters in the company's constitution that could be of concern and what would be your rights under them?



## 2 Governance Duties

### After acceptance of formal appointment

A director's role is potentially an arduous one. It is essential to apply common sense and sound business acumen – the very attributes that presumably led to the invitation to join the Board in the first instance.

We have developed questions that we believe should be applied to the key areas of governance. Reassess your initial responses from time to time to ensure that the conditions under which the appointment was accepted have not changed.

### Evaluation of the Board

An effective Board of Directors will have a culture of trust, ability, candour and diligence that is maintained through continuous self-examination and reinforcement, by careful selection of new directors, and by an effective chairman.

Better decisions will be made when thoughtful debate is encouraged, opinions and ideas are honestly shared, information is thoroughly examined, and the responsibility is equally shared.

- Does the Board elect its Chairman annually at the first Board meeting following the annual general meeting?
- Do all members of the Board and any Board committees attend all meetings?
- Are all meetings run in a competent and professional manner?
- Do all members take their role as a serious commitment?
- Are members too engrossed in the day-to-day detail of the business to deal appropriately with policy-setting and general supervision?
- Are the Board and committee meeting agendas and accompanying notes distributed in sufficient time to allow adequate preparation?
- Are meetings accurately recorded in clear minutes, which are promptly distributed to all members?
- Have members demonstrated their commitment to staying current on latest developments in the areas of information technology and corporate governance?
- Is there a formal and transparent process for setting director remuneration? Are any directors involved in setting their own remuneration levels?
- Is there a formal process for evaluating Board performance and individual directors?

### For issuers only

An issuer is a listed company that issues shares to the public through the New Zealand Stock Exchange (NZX).

- Are all executive directors holding office for a term of five years retired from the Board (for re-election)?
- Are at least one-third of the directors (or if the number of directors is not a multiple of three, then the number nearest to one-third) retired from office at the annual meeting?  
*NB: These directors are eligible for re-election at that meeting. Those who retire should be those who have been in office the longest since they were last elected or deemed elected. For exceptions to rotation, refer to section 3.3.9 of the NZX listing rules.*
- Has any director's remuneration been authorised by resolution prior to being paid?

It is the Board's duty to present to shareholders a balanced and understandable assessment of the company's performance and position. Often this will involve the provision of information additional to the minimum required by law.

### Long-term strategy and planning

- Has the Board approved a long-term strategic plan or business strategy based on recommendations from the Chief Executive Officer?
- Has the strategy been developed in consultation with senior and business unit management?
- Are you satisfied that the strategy has taken into account all anticipated strengths, weaknesses, opportunities and threats, and that it is realistic?
- Is there a succession plan for the senior executives, especially the Chief Executive Officer?

## Policy formulation and monitoring

- Company policies should cover:
  - shareholder relations;
  - risk management;
  - dividend policy;
  - treasury management;
  - delegation of authority;
  - disaster recovery planning;
  - back-up and storage of key data;
  - credit terms and conditions;
  - quality control for goods and services;
  - equal employment opportunity, sexual harassment and non-discriminatory practices;
  - industrial relations;
  - occupational health and safety;
  - environmental strategy;
  - media and public relations; and
  - code of employee conduct.
- Are they properly documented and communicated appropriately?
- Are they reviewed and updated regularly?
- Are random enquiries made to ensure that management is enforcing the policies?
- Does the company have a code of corporate ethics?
- Is the code of ethics communicated effectively throughout the company?
- Do you and the rest of the Board, including the Chief Executive Officer, acknowledge the importance of the code and your commitment to it through your own actions and performance?

## Quality of Board reporting and management information systems

Board papers should contain enough information to allow sound decision-making. A clear recommendation should also be stated.

- Who prepares the Board papers and what guidance are they given for including/excluding information?
- Is the information produced in a concise and logical format and are explanations to queries readily obtained?
- Are there adequate briefing papers, including specialist advice, for unusual matters to be discussed and voted on by the Board?
- Do audit reports on the company's internal controls indicate that information provided by management is reliable?
- Do the directors receive adequate reports from all other Board committees?
- Are the monthly results explained in sufficient detail to give an accurate understanding of the company's performance?
- Do the Board papers have a good balance of financial and non-financial performance metrics? Are the performance metrics linked to the company's strategy and value drivers?

## Short-term budgeting and monitoring

- Is there a formalised budget and forecasting procedure?
- Is short-term planning in line with long-term corporate objectives and plans?
- Are the budgeted results compared with actual results and deviations explained and forecasts adjusted where necessary?
- To determine the company's relative position in the industry, are the actual results compared with those of major competitors and/or industry averages?

## Management performance evaluation

- Is there a system in place for the regular evaluation of senior management, with the results reported to the Board on a timely basis?
- Are any problem areas communicated to the personnel involved and appropriate action taken?
- Is senior company management suitably qualified, with a proper mix between formal education and experience, to handle their positions – especially those in the higher-risk areas of the company?
- Are management compensation schemes linked to performance metrics, either short-term or long-term? Are the performance metrics linked to the company's strategy and value drivers?
- Do performance goals and targets drive performance or are they so unreachable that they are demotivating?
- Are bonuses or incentives so significant as to promote inappropriate behaviour by senior executives in maximising company performance? Do they promote a short-term rather than a long-term focus?

## Risk management

Risk management is a way of viewing a company's operations and has a significant impact on long-term viability. In terms of the company's objectives, risk can present either a hazard or an opportunity, and therefore directors should closely monitor risk management activities.

You should be asking the following questions:

- What are the most significant risks faced by the company and how are they managed?
- Do practices comply with the Australia/New Zealand Risk Management standard AS/NZS 4360: 2004? This standard sets out a proactive and rigorous decision-making and planning process and deals with the effective allocation of resources.
- Are identified risks only those likely to affect achieving the company's objectives?
- Is risk management performance monitored and reported regularly to the Board?
- Are the roles and responsibilities for risk management clearly defined?
- How is risk management integrated with the internal, external and quality assurance functions?
- Does risk management have the active, ongoing support of the Chief Executive Officer and the senior management team?
- Has the Board approved and provided guidance to management on what is acceptable risk?
- Are there processes for identifying new risks as well as tracking existing risks?
- Is risk management addressed in the strategic or corporate plan?
- Is risk management seen as the responsibility of internal audit or embraced throughout the company?
- Are there appropriate rewards and recognition for compliance with procedures and, conversely, sanctions for failing to comply?
- Has a framework been developed to ensure compliance with all relevant laws and regulations?

## Quality of internal systems of control

- Have guidelines for policies and procedures been established for operational, financial and compliance control?
- Is there an appropriate system to ensure timely action is taken on internal control recommendations made by the internal and external auditors?
- Has management developed or instigated a strategy or control plan to mitigate the risk of fraud effectively?

## Financial reporting and filing procedures

- Are there adequate procedures or checklists in place to ensure that financial statements comply with applicable financial reporting standards and that disclosures in the annual report comply with the Companies Act 1993 and Financial Reporting Act 1993?
- Are procedures adequate to ensure that annual reports or financial statements are distributed to shareholders and filed with the regulatory authorities within the prescribed time period? Note that this information can be distributed electronically as a summary directing recipients to a website for full documentation and a request for a hard copy if desired.

The Corporate Governance in New Zealand, Principles and Guidelines recommend the following questions are considered:

- Does the annual reporting include information about each director, identify which directors are independent, and include information on the Board's appointment, training and evaluation processes?
- Is there a rigorous process for assuring directors of the quality and integrity of entity financial reports, including their relevance, reliability, comparability and timeliness?
- For issuers, is there an effective system of internal control for reliable financial reporting?
- Has the Chief Executive, the Chief Financial Officer (or equivalent officers) and at least one other director of publicly owned entities certified in the published financial report that it complies with generally accepted accounting standards and presents a true and fair view of the financial affairs of the company?
- For issuers, is there a clear and robust internal process for compliance with the continuous disclosure regime? (This should include Board examination of continuous disclosure issues at each Board meeting.)

Guidance to assist directors in identifying and fulfilling their reporting responsibilities with respect to preparing an annual report under the Companies Act 1993 and Financial Reporting Act 1993 is contained within the Warrant of Fitness supplement (a related but separate booklet).

The form and content of financial statements will vary over time depending on the size, type and ownership of the company. It is important, therefore, that checklists are kept up-to-date and that they also consider differential reporting.

## Public relations and communications

Public relations and communications are important as they identify and manage a company's reputation with its stakeholders.

- Is there a media and public relations communications policy in place covering areas such as:
  - designation of a company spokesperson;
  - explicit prohibitions on speaking on behalf of the company;
  - dealings with shareholders, analysts, major investors and other stakeholders; and
  - communication plans and responsibilities in the event of crisis?
- Are all stakeholders treated equally, with information disseminated to interested parties at the same time?
- Are public communication requirements and policies an integral part of procedures relating to issues such as product recalls?
- Are different channels for communication, such as media releases, annual reports and corporate websites, managed to ensure consistency?  
*NB: The Corporate Governance in New Zealand, Principles and Guidelines recommend that publicly owned entities maintain an up-to-date website providing a comprehensive description of their business and structure, commentary on goals, strategies and performance, key corporate governance documents and all information released to the stock exchange including reports to shareholders.*
- In the case of listed companies, are there controls in place to ensure that all material information is identified and disclosed to the market as required under the continuous disclosure regime in the Securities Markets Act 1988?

## Review of the audit function

Note: This may be performed by the audit committee and reported to the Board. However, you should still satisfy yourself that the questions have been addressed.

## Internal audit

The internal audit function can come in many shapes and sizes and can have quite diverse functions and responsibilities from one entity to another, and all can be appropriate for entities' particular circumstances.

- Does the internal audit function report directly to the Board or audit committee rather than management? If so, are you regularly reviewing the internal audit?
- Are there policies to ensure the scope of the internal audit function is appropriate to the circumstances and that the information flow is not inappropriately restricted?

- Are there policies to ensure that the effectiveness of the internal audit function, including the quality of reporting, is appropriately measured?
- Has the internal audit programme been aligned with the company's risk management processes?
- Where appropriate, has the internal audit programme been aligned with that of the external auditor to ensure there is no unnecessary duplication?

## External audit

External auditors, in their statutory role as auditors of financial statements, are ideally positioned to provide independent comment on the standards and quality of the internal control environment, including internal audit.

- Are you, as part of the Board or audit committee, responsible for the selection of the external auditor, rather than delegating this responsibility to the Chief Financial Officer?
- Has the Board or audit committee adopted an independence policy giving guidance as to what level and nature of non-audit involvement is appropriate?
- Are you confident of the external auditor's independence? Has the auditor provided the Board or audit committee with a statement of all non-audit fees paid to them, descriptions of the work performed for these fees, and the rationale as to why this additional work has not impacted on their independence?
- Are you in a position to ensure that the issues raised by the external auditor have been satisfactorily resolved?
- Have you discussed with the auditor their views about contentious areas in the financial statements and alternative accounting treatments with their potential effect on the financial statements?
- Where the Board has requested the external auditor to concentrate their emphasis on specific areas, have you reviewed the results and are you satisfied that corrective action is being taken where appropriate?
- Where applicable, are you satisfied that the external auditor has looked to the internal audit work in determining their work programme to maximise the efficiency and effectiveness of the external audit?
- Have you reviewed the draft audit opinion and are you satisfied with what it says?
- Have you reviewed the letter of representation and do you agree with all the representations being made?

## Audit committee

Audit committees are key to a company's corporate governance and risk management processes. Your additional duties as an audit committee member may be significant and you should consider carefully whether you can fulfil these duties diligently before accepting.

### • Before appointment to the audit committee:

- do you fully understand the role of the internal audit department? Are there clear lines of communication between the Chairman of the audit committee and the head of the internal audit function?
- do you have, or have you had, any relationship with the company and management that may impair your independence as an audit committee member?
- are you comfortable that you have an appropriate level of financial expertise that will allow you to fulfil your duties to enquire of management as to the accuracy of the financial statements?
- is the audit committee made up of independent non-executive directors? *Ideally, the audit committee should only comprise non-executive directors.*
- do the current audit committee members perform their duties diligently and does the Board fully support the audit committee?
- are meetings held regularly and do all audit committee members attend? *The audit committee should normally meet at least three times a year and a statement to this effect should be recorded in the annual report.*
- has the audit committee adopted a formal written charter that has been approved by the Board of Directors that appropriately sets out membership requirements, structure and responsibilities? This should include the review of all financial statements to be released by the company and the regular review of compliance with internal systems and controls and with statutory and regulatory requirements.
- if a formal charter has been adopted, is this reviewed and updated on a regular basis?
- is there a policy for committee member rotation? For listed entities, it is a requirement that the external auditor or lead audit partner be changed at least every five years.

### • Following appointment to the audit committee:

- are processes in place so that the Board of Directors is regularly informed and updated on corporate financial matters?
- have you interrogated management as to the financial accuracy of the year-end and six-month financial statements? Have you especially focused on areas of judgement, unusual or complex items and their accounting treatment, and significant variances from the prior year and budget?
- is the committee keeping up with changes in legislation and new best practice statements that will affect the duties of the audit committee?
- are you actively involved in monitoring the risk management process of the company? Are management fulfilling their duties to identify risks and managing them?
- does the audit committee have the authority to investigate identified areas of concern, including the authority to engage external independent advisers?
- does the audit committee have direct communication with, and unrestricted access to, the external and internal auditors?

## Shareholder distributions

Directors voting in favour of certain transactions under the Companies Act 1993 must sign a certificate to the effect that the company will meet the solvency test. Transactions requiring solvency certificates from directors include:

- distributions of property by the company;
- payment of dividends;
- agreements by the company to guarantee the obligations of a shareholder;
- redemptions of, or repurchases of, the company's own shares; and
- giving financial assistance for the purchase of a company's own shares.

Directors are also required to consider the question of solvency before completing amalgamations, providing for shareholder discount schemes and compulsorily acquiring shares from minority shareholders.

The solvency test itself is twofold. Immediately after a distribution the company must:

- be able to pay its debts as they become due in the normal course of business; and
- have assets greater in value than its liabilities, including contingent liabilities.

When signing a solvency certificate, directors must in each case state their reasons for holding the opinion that the solvency test has been satisfied. Although directors in other countries must satisfy themselves that solvency criteria have been met, New Zealand is unique in requiring certification of the reasons for forming such an opinion. In ascertaining whether the value of a company's assets is greater than the value of its liabilities (including contingent liabilities), the directors:

- must have regard to the most recent financial statements of the company and all other circumstances that affect or may affect the value of the company's assets and the value of its liabilities, including contingent liabilities; and
- may rely on valuations of assets or estimates of liabilities that are reasonable in the circumstances.

In determining the amount of a contingent liability, directors can take into account factors including the likelihood of the liability and the estimated value of any corresponding claim that the company may be able to make to reduce or extinguish it.

The requirement for a subjective value to be placed on contingent liabilities makes it important for directors to consider seeking expert independent advice prior to signing a solvency certificate.

If circumstances change between the time of the signing of a certificate and the completion of the transaction to which the certificate relates, the directors will need to re-evaluate whether the solvency test has been met. If the directors are no longer satisfied as to the solvency of the company at the relevant time, the proposed transaction that was the subject matter of the certificate is prohibited, and failure to comply with the prohibition is an offence.

If the company does not satisfy the solvency test immediately after the distribution of property to shareholders or the payment of dividends, a director who signed a solvency certificate may become personally liable to repay to the company so much of the distribution or dividend as cannot be recovered from shareholders.

## Funding

- Are the funding requirements of the company addressed and reviewed by the Board on a continuous basis?
- Is compliance with loan agreement covenants monitored by the Board? Are forecasts prepared to identify possible covenant breaches in the future?
- Are cash flow and profit forecasts, which are tabled before the Board, compared with actual results to determine the accuracy of those forecasts?

- Are forecast cash flow shortages addressed and surpluses appropriately and promptly invested, and is the Board aware of all key loan repayment dates to ensure that the company does not default?
- Does proposed funding, whether debt or equity, comply with any restrictions placed on the company by stock exchange rules, existing trust deeds, loan agreements or the company's constitution?
- Is the funding in line with the company's overall risk management strategy (including target credit rating)?
- Does proposed funding adversely affect the debt/equity ratio?
- Is the company able to service extra funding?
- Is the level of risk (e.g. exchange risk, credit risk, interest rate risk) associated with any funding or placement acceptable and is it in line with the company's overall risk management strategy?
- Given the purpose of the funding (e.g. working capital, asset acquisition, bridging finance) are the terms, nature, risk profile, source and timing appropriate and matched to that purpose?
- Does the Board have a good understanding of funding arrangements using complex financial instruments or structures, and the financial implications arising from their use?
- Has the tax position, availability, relative cost, effect on control of the company, rate of return and all associated costs for the funding been fully considered?
- Has the company received advice from appropriate professionals (e.g. brokers, corporate advisers, accountants, legal advisers), and do they envisage any problems with the desired course of action?
- Are there reasonable grounds to believe that the experts and advisers used by the company are competent and independent?
- Does the company have any plans to issue prospectuses in order to raise funds from the public?
- Where a prospectus is to be issued, has a due diligence committee of both executive and non-executive directors been formed to oversee the process?
- Are you satisfied that the prospectus contains no representations or statements, promises, estimates or forecasts that are false, misleading or deceptive?
- Has every prospectus issued been properly prepared in compliance with the requirements of the Securities Act 1978 and Securities Regulations 1983?
- Have all the relevant parties been sent copies of the appropriate documents on a timely basis?
- If the equity or debt is to be listed on the stock exchange, has the company complied with listing requirements?

### Acquisitions, mergers, divestments and takeovers

- Is the company actively involved in investing in the shares of listed companies?
- If so, are the shareholdings carefully monitored to ensure that directors are not in a situation where they have breached or, if they acquire any further holdings in a company, may breach restrictions in relation to the percentage of shares held?
- Does the company carry out due diligence procedures for all major acquisitions?
- Are acquisitions subject to an integration plan to maximise acquisition benefits?
- Are post-transaction evaluations performed, particularly for acquisitions failing to meet expectations, assessing management's plans to ensure future success?
- If the company has targeted a specific company or business for a takeover:
  - has the takeover offer complied with the relevant legislative requirements?
  - have you considered the need for accountants, or other specialists, to conduct a due diligence review of the target company?
  - have the tax implications of the takeover been considered?
  - have you ensured that the takeover fits within the strategic plan?
- Does the company have a documented takeover defence strategy, and does it include tactics that secure a better deal for the shareholders and protect the legitimate interests of the company?
- Do the directors receive regular analyses of trading activity in the company's shares that highlight areas of concern?
- Are you aware of the beneficial ownership of all large shareholdings?
- If the company is potentially subject to a takeover offer:
  - are you satisfied that the response to any formal takeover offer is in conformity with all relevant legislative requirements?
  - are any statements of reply misleading and has all appropriate information been given to shareholders?
  - have you received enough information from the other party to make an informed decision?

### Other questions

- If you are involved as a trustee of the company superannuation fund, are you satisfied that:
  - all actions taken have been in accordance with the trust deed?
  - due consideration has been given to taxation, financial statements and, where applicable, deficiency/surplus aspects of the fund?
  - the fund complies with the Superannuation Schemes Act 1989?
  - the fund meets all the disclosures required by the Financial Reporting Act 1993?
- Is your knowledge of the business and related matters up-to-date?
- Are all professional advisers properly qualified and are you satisfied with their performance?
- Are you satisfied the company is adequately insured against all significant risks?



## 3 Regulations and Law

### Directors' guidance

Directors (including deemed directors) need guidance today more than ever because of the many legal duties now imposed on them, irrespective of their companies' size.

Frequently the landscape will be uncharted so a thorough knowledge of a director's duties is essential.

Many director's duties and responsibilities were established by case law that has now been codified into legislation with clearly defined penalties. Some penalties are significant and apply to each individual director – even if it was the company's management that failed to carry out an obligation.

While it is possible, and often necessary, for a company director to delegate authority for the performance of some of these duties, the Courts have held, and now legislation confirms, that it is not possible to delegate the responsibility for ensuring they are properly carried out.

If a Court needs to consider a director's conduct, it will be assumed that they possess the competence, knowledge and expertise expected of a director fulfilling that role in the company. PricewaterhouseCoopers' view is that the Court would not be impressed by such excuses as: the directors were not aware of their legal responsibilities; or the directors were unaware of, or failed to keep themselves informed about, the true position of the company.

Some of the important common law, legislative duties, guidance and expectations that attach to the position of company director are set out in this section. Furthermore, it should be noted that these duties, and the related offences and penalties, may apply even if:

- you are merely an alternate or acting director;
- you are solely an employee exercising the delegated management responsibilities of the Board;
- you are a shareholder carrying out the functions of a director; or
- your appointment as a director was invalid or unauthorised.

### Legislation

Legislation affecting companies requires directors to:

- ensure adequate measures are in place to prevent and detect falsification of accounting records;
- prepare and issue the annual report, including audited financial statements, where applicable, within five months of balance date (or three months if the company is listed on the New Zealand Stock Exchange);

- ensure financial statements comply with generally accepted accounting practice in New Zealand;
- issue signed solvency certificates whenever:
  - there are planned distributions;
  - discount schemes to shareholders are proposed;
  - shares are repurchased;
  - options redeeming shares are exercised;
  - financial assistance to acquire shares is offered, and
  - an amalgamation is proposed;
- determine and certify what is a fair and reasonable consideration for the issue of shares or the repurchase of shares on issue;
- fulfil specific duties in relation to takeovers;
- fully disclose all share dealings in the company to the Board;
- record material relevant interests in any transaction in the interests register;
- avoid improper use of the position of director or the use of any information obtained through that position for personal gain or to cause detriment to the company;
- respond appropriately to written requests from shareholders for information held by the company;
- ensure the company does not carry out business in a manner that is likely to create substantial risk of serious loss to creditors;
- ensure the company does not incur an obligation unless there are reasonable grounds that it can meet the obligation; and
- certify that directors' remuneration is fair to the company.

The Securities Markets Act 1988 places further obligations on directors of listed companies including:

- continuous disclosure of material information to the market; and
- an obligation for directors and officers to disclose securities trading within five days of the time it occurs.

## Regulations

There are regulations in place in many areas covering the environment, trade practices, privacy, industrial relations, occupational health and safety, employment, dangerous goods, buildings, customs and taxation. Many of these emanate from legislation.

## Common law

Duties under common law include:

- acting in good faith in the best interests of the company as a whole;
- exercising such a degree of care, skill and diligence as might reasonably be expected from a director's ability and experience;
- exercising the powers granted by the constitution for a "proper purpose";
- refraining from, or preventing, any act that would adversely affect decision-making in relation to the activities of the company; and
- avoiding conflicts of interest with the company.

All of these duties have been codified in company legislation for some time.

## Offences

A director who fails to carry out their statutory responsibilities may have committed a personal offence under the appropriate legislation, and the penalties are severe.

Companies' legislation will be breached if a director fails to:

- take all reasonable steps to ensure the company's accounting records correctly record and explain the transactions of the company and comply with the Companies Act 1993 and Financial Reporting Act 1993;
- take reasonable steps to ensure that the company kept, for the specified minimum period, company records such as the constitution, director details, minutes of shareholder and director meetings, interests register, written communication to shareholders, share registers and its financial statements;
- ensure that the financial statements and an annual report are prepared and signed within five months of balance date;
- take reasonable steps to ensure the Board has taken adequate measures either to prevent the accounting records from being falsified or to detect any falsifications;
- provide information or explanations to the auditors;

- ensure where accounting records are maintained overseas that the company has adequate accounts or records in New Zealand to disclose with reasonable accuracy the financial position at least six-monthly;
- provide a copy of the annual report on written request from a shareholder as soon as practicable;
- make available at all reasonable times the annual report by electronic means from the date notice is given to shareholders until the next accounting period;
- ensure an annual return is filed with the Registrar of Companies within the required period;
- ensure the certificate of incorporation, constitution, share register, register of directors and address for service of documents are available for inspection by the public and also that minutes of shareholders' meetings, written communications to shareholders, directors' certificates and the interests register are available for inspection by the shareholders;
- take reasonable steps to ensure that the Board notifies the Registrar of any change in the constitution, issue of shares, acquisition of own shares, or changes in directors;
- certify that the consideration for a share, option or convertible securities issue, or financial assistance to acquire shares in the company, is fair and reasonable or fail to deliver to the Registrar a copy of the certificate;
- notify the Board and record in the interests register, any relevant interest in shares issued by the company or interest in a transaction or proposed transaction;
- sign a certificate stating the solvency test has been met when voting in favour of a distribution or the provision of financial assistance to acquire company shares; or
- check the accuracy and completeness of statements made in respect of documents required by the Companies Act 1993 and Securities Act 1978.

## Directors' liabilities

Individual directors may also be liable if:

- they fraudulently take, apply, conceal or destroy any property of the company;
- they act with intent to defraud a creditor or creditors of the company or do anything that causes material loss to any creditor;
- they falsify, destroy, alter or mutilate any company record with the intent to defraud or deceive;
- they knowingly are a party to the carrying on of any business of the company in a reckless manner;
- they induce a person to give credit to the company through false pretences or fraud;
- they knowingly are a party to the carrying on of any business of the company with intent to defraud creditors of the company or creditors of any other person or for any fraudulent purpose;
- they are involved in securities dealings where by virtue of the position held as an insider, price-sensitive information not available to the market is acquired and used for personal gain, i.e. insider trading;
- the financial statements do not comply with applicable financial reporting standards (assuming the company is not an exempt company);
- there is a failure to have the financial statements audited when an audit is required;
- the company fails to lodge the audited financial statements with the Registrar of Companies within 20 days of the date when they are required to be signed and where it is required to do so;
- the Board does not allow the auditor to attend shareholders' meetings or does not allow an auditor to address the shareholders on any part of the meeting business that concerns them as auditor;
- the Board fails to notify each shareholder that financial assistance has been given to another person to acquire shares in the company;
- the company does not provide shareholders on request with a statement of rights with regard to their holdings and how those rights relate to other classes of shares; or
- the company fails to register a shareholder unless the Board has resolved otherwise.

*NB: An individual director would not be liable for these offences if it could be proved that the director or directors took all reasonable steps in the circumstances to ensure that the Board or company complied with the legislation.*

## Legislative breaches

In various situations, an offence committed by a company can involve its directors in criminal liability – usually it is aiding, abetting or knowingly conspiring with the company to commit the offence. In some circumstances, for example in offences committed against the Resource Management Act 1991, lack of intent is not a defence.

Potential criminal liability may arise for a director where the company:

- acts without a resource consent when one is required or does not comply with an enforcement order, abatement notice or water shortage directive;
- pollutes, unlawfully disposes of trade waste or leaks, spills or releases harmful substances; or engages in misleading, deceptive or unconscionable conduct;
- makes false representation regarding products;
- fails to provide a safe working environment that has adequate emergency procedures;
- does not maintain an accurate record of accidents and fails to notify the proper authorities;
- requires the giving of covenants that are designed to, or would be likely to, lessen competition;
- attempts to fix a minimum price for resale by its customers;
- supplies goods that do not comply with product safety and information standards;
- accepts payment for goods where there are reasonable grounds to expect it will not be able to supply them;
- manufactures, stores, supplies, transfers, sells or uses dangerous goods without a licence or other than in accordance with specified conditions; or
- delays or fails to report an accident involving dangerous goods.

## Penalties

The civil and criminal penalties imposed against directors for not properly performing their duties are severe.

- **Financial Reporting Act 1993**

The maximum penalty for making false or misleading statements in documents required by the Financial Reporting Act 1993 is \$200,000 or five years' imprisonment.

Failure to produce financial statements within five months of the period end results in an automatic infringement fee of \$7,000, and if financial statements are not filed it can result in fines of up to \$100,000 being imposed on each director individually.

Failure to issue financial statements that do not comply with applicable financial reporting standards can result in fines of up to \$100,000 being imposed on each director individually.

- **Securities Act 1978**

The maximum penalty for knowingly including an untrue statement in an advertisement or registered prospectus is a fine of \$25,000, or imprisonment for five years, or both.

- **Securities Markets Act 1988**

The maximum penalty for non-compliance with the Securities Markets Act 1988 is \$30,000. An offence is committed when directors and officers fail to disclose information in accordance with a directors' and officers' disclosure obligation and when an order of the commission concerning continuous disclosure is contravened.

A maximum \$5,000 fine can be imposed where a copy of an interests register is not provided on request.

- **Resource Management Act 1991**

The penalty for contravention of the Resource Management Act 1991 is up to \$200,000 plus \$10,000 per day while the offence continues, or two years' imprisonment, or both.

The penalties for contravention of the other legislation are, in some cases, equally severe. Remember, these penalties are imposed against each individual director and, as previously mentioned, in the case of the Resource Management Act 1991, it is not necessary to prove that the defendant intended to commit the offence.

## Tax

A range of civil and criminal penalties can be imposed on taxpayers for non-compliance. Civil penalties include "shortfall" penalties which are imposed where the Inland Revenue Department considers a tax shortfall has occurred as a result of a taxpayer's act or omission. Shortfall penalties are set at:

- 20% of the tax shortfall where the taxpayer has failed to take reasonable care, or has taken an unacceptable tax position;
- 40% for gross carelessness;
- 100% for an abusive tax position; and
- 150% for evasion.

Tax shortfall penalties are generally levied against the taxpayer, but in the case of PAYE and other withholding taxes, the Commissioner of Inland Revenue may apportion a shortfall penalty between the company and officers (including directors) involved in failing to deduct or withhold the tax or in applying the amount deducted or withheld to something other than payment to the Commissioner.

Civil penalties also include late payment penalties. Taxpayers are required to pay tax on time. Where any tax is paid late, an initial penalty of 1% of the amount outstanding is charged, and an additional 4% late payment penalty is charged if the payment is not made within seven days of the due date. Further monthly incremental penalties of 1% per month are charged until full payment is made. Interest is also charged on the initial unpaid tax and accrued interest.

Where a criminal offence was caused by an act or omission of a company director, that director faces the prospect of a fine of up to \$50,000, or a prison sentence of up to five years. Criminal offences include:

- failing to keep proper tax records;
- failing to provide information to the Commissioner;
- failing to apply for GST registration;
- providing incomplete, false or misleading information;
- failing to withhold or deduct tax; and
- failing to account for tax deductions or tax withheld.

Anyone aiding or abetting another person committing an offence faces the same penalty as that other person.

Where an arrangement has been entered into by a company that would prevent the company satisfying its tax liabilities, the Commissioner of Inland Revenue is able to collect those taxes directly from the directors as agent for the company. The Commissioner's power in this respect also extends to deemed corporate equivalents (for example, trustees of unit trusts face the same risks).

- **Tax obligations**

The general responsibilities of all taxpayers, including companies, under all tax laws are to:

- determine correctly the amount of tax payable under the tax laws;
- deduct or withhold the correct amounts of tax from payments or receipts when required to do so by the tax laws;
- pay tax on time;
- keep all necessary information (including books and records) and maintain all necessary accounts or balances required under the tax laws;
- disclose to the Commissioner, in a timely and useful way, all information (including books and records) that the tax laws require the taxpayer to disclose;
- co-operate with the Commissioner in a way that assists the exercise of the Commissioner's powers under the tax laws, to the extent required by the Inland Revenue Acts; and
- comply with all the other obligations imposed by the tax laws.

- **Income tax**

The principal obligations on taxpayers under the Income Tax Act itself are to:

- calculate and pay income tax;
- pay provisional tax;
- satisfy any withholding liabilities such as PAYE, resident withholding tax, non-resident withholding tax, approved issuer levy, and non-resident contractors withholding tax; and
- comply with any other obligations specified in the Act.

Under certain circumstances, where these obligations are not met, the income tax owed by a company may be recovered from the directors personally as agent of the company.

These provisions can be invoked when:

- an arrangement has been entered into in relation to a company;
- an effect of the arrangement is that the company is unable to satisfy any existing or future tax liability (for income tax, civil penalties or interest); and
- it is reasonable to conclude that:
  - had a company director made all reasonable inquiries into the affairs of the company at the time of entry into the arrangement, the director would have anticipated that a tax liability existed; and
  - a purpose of the arrangement was that the company be unable to satisfy a tax liability.

Avoiding a tax liability need not be the dominant or only purpose of the arrangement, and the tax liability need not be in existence at the time the arrangement was made. It must be a liability that a director could have anticipated upon making reasonable enquiries.

These provisions will not apply where:

- the Commissioner was a party to the arrangement;
- the liability as a result of the arrangement has already been satisfied; or
- the arrangement was entered into when the company was under statutory management.

Furthermore, directors will not be liable when they can satisfy the Commissioner that they have derived no benefit from the arrangement and either:

- formally recorded their dissent in relation to the arrangement and notified the Commissioner in writing of this at the first reasonable opportunity; or
- satisfied the Commissioner that they were not involved in the executive management of the company at the time; and
- had no knowledge of the relevant aspects of the arrangement.

Unless a director can rely on one of the above statutory defences, each director will be jointly and severally liable for the full amount of the tax liability.

Special rules apply where the company has been liquidated and, in general, the Commissioner may issue or amend an assessment as if the company had not been liquidated, nominating one or more persons who are considered liable for this purpose.

- **Goods and services tax (GST)**

Company taxpayers also have various filing and payment obligations under the Goods and Services Tax Act 1985 and failure to comply with these may result in the imposition of penalties.

## Directors' rights

Two of the more important rights as a director are:

- the right to receive all internal information concerning the company's affairs; and
- the right of indemnity from fellow directors where there is equal culpability for a breach of duty.

The Companies Act 1993 states that as long as a director has acted in good faith, made proper enquiry, and had no knowledge that reliance was unwarranted, they can rely on reports, statements and financial data or other information prepared or supplied by a competent employee, a professional adviser or expert, or another director or committee of directors.

These rights, which arise from common law and statute, may be set out in the constitution of the company or the original legal documents to establish the company, such as the shareholders' agreement. As the rights incorporated into the constitution and/or shareholders' agreement will vary from company to company, it is important to be familiar with all aspects of these documents. In addition, if they hold shares in the company, directors have the same rights as other shareholders.

## Indemnities

If its constitution allows it, a company can indemnify or take out insurance for the benefit of directors (within limits) against the costs associated with defending or settling a claim for any acts of omission in their capacity as a director or employee. The indemnity and insurance cannot cover any criminal liability or liabilities arising from not acting in good faith or in the company's best interests.

If insurance is taken out, directors must certify that the cost is fair to the company and ensure details of the insurance or indemnity are entered in the interests register. The particulars must also be disclosed to shareholders in the annual report.

## Warnings

It is rare for a sudden financial crisis to overtake a company – the process usually takes at least several months and during that time, warning signs will be apparent.

It is important to be able to detect the warning signs of potential problems so that appropriate action can be taken at the earliest possible opportunity. The steps required to rectify the situation will depend on the circumstances and will be a matter for which a director will be responsible. In certain instances it may be appropriate to seek outside professional advice.

It is important to note that a director may be risking personal liability for the debts of the company incurred from the date it is unable to meet its debts.

Some of the warning signs which should be identified at an early stage are set out below. While no single sign or group of signs means your company is in trouble, they nevertheless highlight the areas and matters of concern that should be investigated.

The following points have been developed to help identify what problems may become significant at an early stage:

### • Management and the Board

- Are the Chairman and Chief Executive Officer dominating meetings and making decisions without first consulting the Board?
- Is the Board finding it more difficult to make decisions?
- Is the flow of information to the Board being delayed, especially in problem areas?
- Has there been an inadequate examination of corporate errors?
- Is there a worsening relationship between the directors and Chief Executive Officer?
- Are you aware of instances where appropriate Board authorisation has not been obtained by the Chief Executive Officer or management?
- Have there been a number of recent director and senior management resignations?

- **Financial matters**

- Has there been a slowdown in the receipt of financial reports?
- Are the explanations for variances from budgets inadequate?
- Has there been a deterioration in the collection of debts and payments to creditors?
- Is the company's gearing or liquidity a problem, or is it forecast to become a problem?
- Is the company complying with all loan agreement covenants?
- Is the company seriously exposed to interest rate or currency fluctuations?
- Are there any off balance sheet agreements that could trigger liabilities, for example, in the event the company's share price falls?
- Does the company follow an aggressive approach to tax planning?
- Have there been any unexpected losses or unfavourable accounting adjustments?
- Are there any signs of lack of reliability of key financial systems?

- **Other warning signs**

- Has the company's share price fallen sharply recently?
- Has the credit rating of the company been downgraded?
- Has the media been commenting adversely on the company's performance and products?
- Have staff turnover and morale been deteriorating?
- Have there been frequent customer complaints about the quality of goods or services provided?
- Have there been any shortages of raw materials or inventories, resulting in the late delivery of orders and indicating a loss of supply markets or late payment of creditors?
- Are the auditors' reports, internal or external, showing an increasing number of control problems and areas of disagreement with management?
- Is there a high level of related party transactions?
- Are larger numbers of serious control deficiencies being reported by the auditors?
- Is there a growing number of unresolved audit issues that are the subject of disagreement between management and the auditors?
- Has the external auditor been changed because of disagreements with senior management?
- Is there a major deterioration in any of the company's key markets?

- Are there any problems in any of the company's key industries that could affect it?
- Have there been any other strategic changes in the company's operating environment?
- Has there been a drop in sales order activity, especially in forward sales?

### **Prevent insolvent trading**

The steps used to prevent insolvent trading will depend on the circumstances. Generally, the most important action is to ensure that proper accounting and financial records are maintained. If the records are kept up-to-date, solvency can be regularly monitored and directors fully informed of the company's position.

When a company goes into liquidation and the Courts hold that a lack of adequate accounting records or financial statements contributed to the company's demise, or has made it difficult to assess the company's financial position, a director may be held personally responsible for all or part of the company debts.

If it is believed a serious operational or financial problem is on the horizon, and a director is unable to persuade fellow directors of their concerns, they should insist on having their views recorded in the Board minutes. If this is not done, the director should deliver a letter to the company expressing their concerns and take legal advice on their position.

To simply resign, without drawing their views to the attention of fellow directors, would not absolve the director from legal responsibility for the activities of the company during their period as a director, nor would it be a proper discharge of their duties.

Directors should also remember that their duty to act in the interests of the company as a whole, demands more than simply a consideration of the interests of shareholders – it also extends to creditors of the company.



## 4 Further Information

### Other references and guides

There are a number of guides and codes that will help directors to carry out their duties responsibly and ethically and to the highest professional standards.

Examples include the Institute of Directors' Code of Practice for Directors (see [www.iod.org.nz](http://www.iod.org.nz)) and the Securities Commission's Corporate Governance in New Zealand, Principles and Guidelines (see [www.seccom.govt.nz](http://www.seccom.govt.nz)), and directors should make themselves familiar with these codes.

In general, directors must:

- act honestly and in good faith and in the best interests of the company;
- carry out their duties legally using all reasonable endeavours to ensure the company conducts its business in accordance with the law;
- ensure all shareholders are treated fairly;
- avoid conflicts of interest;
- be diligent, attend Board meetings and take the time to be familiar with the company's business and environments, and the statutory and regulatory and other requirements;
- keep the company's confidentialities; and
- ensure the company has approved procedures for buying and selling shares in the company by directors or their relatives or associates.

Overall, directors must act in accordance with their fiduciary duties, complying with the spirit as well as the letter of the law. They should also remember that they have not only purely legal requirements as directors, but they should also have high ethical and moral standards of behaviour.

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