REQUIREMENTS FOR DEBT SECURITY PROSPECTUSES

ACCOUNTING FOR INVESTMENTS BY THE BORROWING GROUP IN NON-GUARANTEEING SUBSIDIARIES

STATEMENT OF PROPOSALS BY THE SECURITIES COMMISSION FOR AMENDMENTS TO THE SECURITIES REGULATIONS 1983

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PART I

THE POLICY ISSUES

1.0 Introduction

1.1 The Commission has undertaken a review of the provisions of the Second Schedule ("the Second Schedule") of the Securities Regulations 1983 ("the Regulations") as they relate to the treatment of investments by the borrowing group in its non-guaranteeing subsidiaries.

1.2 The Commission has decided to recommend to the Minister of Justice that certain amendments be made to the Regulations and to the Second Schedule. Details of the specific amendments are set out in Part II of this paper.

2.0 Background to the present review

2.1 The present review has its origins in Commission and High Court determinations of appeals by ANZ Banking Group (New Zealand) Limited and UDC Finance Limited, made under sections 69 and 26 of the Act, against decisions of the Registrar of Companies in mid-1990 to refuse to register debt security prospectuses presented for registration by those two companies.

2.2 Both the Commission and the High Court (Eichelbaum CJ)[1] upheld the original decisions of the Registrar. The Commission, when declining the companies' appeals, undertook to review the impact of the relevant clauses of the Second Schedule (particularly clause 24).

2.3 As part of its review the Commission, in February 1992, issued a Discussion Paper ("the Discussion Paper")[2] concerning the requirements in debt security prospectuses for disclosures relating to investments of the borrowing group in non-guaranteeing subsidiaries ("NGS").

2.4 The Discussion Paper reviews the requirements of clause 24 in the light of current market practice, the legal rights of investors in debt securities and broader market considerations, and provides an analysis of various alternative ways accounting information could be presented in relation to investments by the borrowing group in non-guaranteeing subsidiaries.

2.5 The text of the Commission's decision and the High Court judgment are reproduced in the Discussion Paper.

2.6 The Commission received 21 submissions in response to the invitation for comment on the various alternatives outlined in the Discussion Paper. A list of those who made submissions is included as Appendix A.

3.0 <u>The present scheme of the Securities Regulations</u>

3.1 The general scheme of the present regulatory requirements for debt security prospectuses is:

(a) The financial information to be included in the prospectus is that in respect of the "borrowing group" (being the issuer and all the guaranteeing subsidiaries of the issuer);

(b) The borrowing group is required to value investments in its NGS, in the financial statements included in the prospectus, at their cost (less amounts written off) or market value (if ascertainable) whichever is the lower;

(c) There is a prohibition on the use of the equity method of accounting, both as regards the valuation of the issuer's investment in, and the recognition of income from, its NGS and any associated bodies corporate.

3.2 The distinction is made between the resources and profits located or generated within the borrowing group and those domiciled or generated in the NGS because investors in debt securities have recourse upon NGS only by way of realisation of the rights of the issuer and the guaranteeing subsidiaries.

4.0 Public responses to issues raised by the Commission

4.1 A summary of the public responses to the Discussion Paper indicates:

(a) Most respondents consider that the current basis of valuation of the investment of the borrowing group in its NGS is incorrect. One reason for this response is that the regulatory basis will often lead to losses in NGS not being captured in the financial statements of the borrowing group. A further reason is that the regulations do not permit the recognition, in the valuation of the borrowing group's investment in the NGS, of material post-acquisition increases in the net assets of the NGS;

(b) Nearly all respondents consider that the consolidated accounts of the borrowing group (rather than the full consolidated accounts of the issuing group) are the financial statements of most relevance to prospective investors in debt securities. On the other hand a few respondents argue that it is meaningless to draw the borrowing group/issuing group distinction because commercial reality tends to dictate that parent companies will support their subsidiaries, and vice versa, regardless of whether there are guarantees in place or not;

(c) A few respondents consider that investors should be provided with the financial statements of both the consolidated issuing group and the borrowing group. On the other hand two respondents said that inclusion of the full consolidated accounts in a debt security prospectus should be prohibited;

(d) Nearly half the respondents favour the alternative which would require the value of the borrowing group's investment in NGS to be at the net book value as stated in the accounts of the NGS, with the additional inclusion in the prospectus of certain specified financial information concerning the activities and profitability of the NGS;

(e) Many respondents are concerned at the confusion which would be caused for investors if issuers were to be required to include more than one full set of financial statements in a debt security prospectus;

(f) A number of respondents are concerned at the risks to the borrowing entity from exposures to related parties other than subsidiaries, and at the relative lack of information required to be disclosed about guarantors. Some respondents suggested that the borrowing group should include any guarantors of the issue;

(g) Several respondents consider that the Regulations should permit some flexibility (discretion to the directors) in the bases of valuation allowed for investments in NGS;

(h) A few respondents argue that the Commission should take a much broader approach to the review, re-examining the present prescriptive approach for the contents of prospectuses.

(i) A majority of those who responded on the issue of the prohibition on the use of the equity method of accounting favour removal of that prohibition, primarily so that the financial statements in prospectuses would be prepared on a basis more comparable with ordinary published accounts. Some respondents argue that the Regulations should adopt the full equity method of accounting to deal with investments in NGS. A number of respondents do not express a view on this issue;

5.0 The Commission's view of the issues

5.1 Having considered the public responses to the Discussion Paper the Commission has reached the following views:

(A) That there is no need to change the basic structure of the Second Schedule:

5.2 Public comments support the present policy of the Regulations that the most relevant information for investors in debt securities is the financial position, exposures and commitments of the borrowing group.

5.3 This means that the investment of the borrowing group in its NGS should continue to be separately disclosed in the financial statements of the borrowing group as a "one-line" item. There should always be separate disclosure of the assets and earnings of the borrowing group and the borrowing group's interest in its NGS.

5.4 The Commission does not consider that the definition of the borrowing group should be extended to include guarantors (other than guaranteeing subsidiaries) of the securities being offered. It does not seem a feasible alternative. The guarantor will commonly be the issuer's parent company. If the guarantor is the parent the financial statements included in the prospectus would become the consolidated accounts of the parent, the issuer, and the subsidiaries of the issuer which guarantee the issue.

(B) That the basis of the presentation of the results of the NGS in the financial statements of the borrowing group should be changed to a basis similar to the equity method of accounting:

5.5 The Commission is persuaded that use of a modified equity method of accounting will provide an accounting basis which provides information which is more relevant for investors than that which results from the current regulatory requirements. This modified equity method would:

(i) ensure that both the profits and the losses being incurred by NGS are reflected in the stated value of the borrowing group's investment in NGS;

(ii) give a fairer indication to investors of the composition of the overall earnings and resources of the issuing group than does the present regulatory basis;

(iii) use an accepted accounting framework for linking the profitability of the borrowing group and the NGS with changes in the stated values of the borrowing group's investments in its NGS;

(iv) bring the accounting requirements of the Second Schedule closer to current accounting standards.

5.6 The Commission does not support the adoption of the complete equity method of accounting, which would allow line-by-line consolidation of revenues and expenses and assets and liabilities, to account for the investments of the borrowing group in its NGS. To do so would result in the possibility of the commingling of the earnings of the NGS with those of the borrowing group.

5.7 The Commission also does not support the inclusion, in the value of the assets of the issuer, of the amount of any unamortised goodwill remaining from the purchase of an investment in a NGS. This is required under normal equity accounting but is specifically excluded by the valuation bases which it is proposed should be allowed to record the investments of the borrowing group in NGS. Thus the carrying value of the NGS in the books of the borrowing group will normally include the issuer's share of the post-acquisition profits of the NGS but would exclude any goodwill on acquisition not written off. We have termed this the "equity value". The Commission takes this view to help avoid a situation where the carrying value of the NGS is inflated by goodwill factors recognised by the issuer which may not be present if the issuer subsequently is required to realise its investment in the NGS to meet its obligations to creditors.

(C) *<u>That the existing prohibition on the use of the equity method of accounting as it applies to the investments of the borrowing group in associated bodies corporate should be retained:</u>*

5.8 Associated bodies corporate of the borrowing group are generally those entities in which the borrowing group has between 20 and 50% of the equity share capital. Also included in the regulatory definition are investments in any companies which are equity accounted by the reporting entity for normal accounting reporting purposes.

5.9 The effect of this extension is that companies ("investees") in which the reporting entity has less than a 20% shareholding, but where for accounting reporting purposes it is considered the reporting entity has "significant influence" over the particular investee, also come within the regulatory definition.

5.10 The corollary is that companies where there is more than a 20% equity holding, but which are not "associates" for accounting reporting purposes because the borrowing group does not have "significant influence" over the investee, are encompassed by the regulatory definition of "associated bodies corporate".

5.11 In contrast to the position of subsidiaries, over whom the issuer can exercise control, the issuer only has a degree of influence, albeit possibly significant, over the affairs of associated bodies corporate. Because of this difference the Commission considers that it remains inappropriate to include, in the financial statements of the borrowing group, any amount representing the borrowing group's share of the retained profits or retained earnings of associated bodies corporate of the issuer.

(D) That investors in debt securities should be given a reasonable level of understanding about the affairs of those members of the issuing group which do not guarantee the securities being offered:

5.12 Significant elements of an issuing group's business may be carried out by subsidiaries which do not guarantee the debt securities on offer in a particular prospectus. In some cases the bulk of the income earning activities and assets of an issuing group may be outside the borrowing group.

5.13 The borrowing group accounts will correctly identify the range of "real" assets to which the investor has direct access and the fact that the income of the borrowing group may substantially comprise dividends received from the subsidiaries.

5.14 However, details of the activities of the non-guaranteeing subsidiaries, which may also represent potential calls on the resources of the borrowing group, will not be brought to the attention of potential investors under the present regulatory framework. The Commission is of the view that this deficiency should be remedied.

5.15 The Commission's proposed amendments to the Second Schedule include a new clause specifying disclosure requirements related to the investment in NGS.

5.16 The Commission considers the level of detail to be disclosed about the NGS should be sufficient to give prospective investors:

(a) a reasonable indication of how much of the issuing group's activities are conducted outside the borrowing group;

(b) an awareness of the level of financial exposures between the borrowing group and its NGS.

This approach should ensure that the significance of the assets and earnings of those NGS to the position of debt security investors is reasonably well understood.

(E) *That it should not be made a requirement that issuers of debt securities include full consolidated accounts of the issuing group in debt security prospectuses, either as an addition to or as a replacement for the accounts of the borrowing group:*

5.17 Two of the alternatives put forward for comment in the Discussion Paper involve inclusion of the full consolidated accounts of the issuing group in debt security prospectuses. One of these alternatives also includes publication of the borrowing group accounts, the other disclosure of some supplementary information about the NGS.

5.18 The full group consolidated financial statements would normally equate to the statutory accounts produced under the Companies Act 1955 and would be prepared in accordance with generally accepted accounting principles.

5.19 The Commission has given careful consideration to whether or not it should propose that issuers be required to include the issuing group consolidated accounts in debt security prospectuses in addition to or in replacement of the borrowing group financial statements.

5.20 The Commission considers it is still important to draw the distinction between the issuing group and the borrowing group in a debt security prospectus.

5.21 Even though commercial reality may compel issuers to support their NGS, and vice versa, this position will only pertain while the group continues to trade. At the end of the day, in the event of the failure of an issuer to meet its obligations to investors, the legal rights of the various parties become paramount. This must be recognised to avoid misleading investors.

5.22 The Commission acknowledges that there is force in the argument that investors should be given a reasonable indication of both the activities and resources of the overall issuing group as well as those of the borrowing group.

5.23 The Commission believes this indication is best achieved if the primary focus of the debt security prospectus remains on the borrowing group accounts, with the activities and resources of the remainder of the issuing group, the NGS, disclosed separately by the presentation of summary financial data.

5.24 In the Commission's view many, if not most, investors will not appreciate the significance of the NGS to the issuing group as a whole unless the prospectus presents summarised information about those companies.

PART II

THE PROPOSED AMENDMENTS TO THE SECURITIES REGULATIONS 1983

6.0 An overview of the amendments to the Regulations being proposed by the Commission

6.1 The amendments being proposed by the Commission give effect to the decision:

(a) to allow the use of a modified equity method of accounting for the measurement of the financial results and position of the borrowing group; while

(b) ensuring that the effect of the use of the equity method is separately disclosed. Profits or losses of a borrowing group, after tax but before any extraordinary items or equity accounted profits, will always be disclosed.

6.2 The equity method incorporated in the proposed amendments differs from that outlined in SSAP 8 *Accounting for Business Combinations*, as applied to the treatment of unconsolidated subsidiaries, in the following respects:

(i) the option of carrying out a line-by-line consolidation of the results of the borrowing group, and the NGS, in the profit and loss account and balance sheet will not be available to issuers;

(ii) "in substance" subsidiaries are not included in the definition of "subsidiaries" for the purposes of the Regulations;

(iii) the value of investments by the borrowing group in its NGS will exclude any unamortised goodwill remaining from the time of purchase of the NGS.

6.3 A new clause will specify that summary balance sheet and profit and loss account information for the NGS as a group should be included in debt security prospectuses. This information will be required to relate to the same accounting periods as the primary set of financial statements in the prospectus.

6.4 The direct financial exposures of the borrowing group to its NGS, and vice versa, will be required to be identified. Although the existing clauses of the Second Schedule already require some disclosure of exposures to and from various classes of related parties, the Commission considers that the exposures between the borrowing group and the NGS should be separately highlighted.

6.5 An additional requirement is that there should be a reconciliation between the stated value of the borrowing group's investment in its NGS and the amount of share capital and reserves, less minority interests, as shown by the books of the NGS.

6.6 Debt issuers will be required to include a statement, in close proximity to the information about the NGS, to indicate that the information relates to subsidiaries which do not guarantee the securities being offered in the prospectus.

6.7 The information in the summary statements need not be audited, but the auditor will be required to state in his or her report whether or not the information was taken from audited financial statements and, if so, whether it was correctly taken.

7.0 <u>Detail of the amendments being proposed by the Commission</u>

7.1 This section of the paper outlines and explains the detailed changes to the Regulations being proposed. For ease of reference additions to the Regulations are denoted by underlining. A copy of the proposed amendments to the Regulations ("the Amendment") is included as Appendix B.

7.2 Clause 1(2) provides for the Amendment to come into force on 1 September 1994. An appropriate lead time is necessary for implementation of the changes made by the Amendment.

7.3 Clause 2 of the Amendment inserts a new definition in regulation 2 of the Regulations:

> "**'Non-guaranteeing subsidiary'** means any subsidiary of an issuer that is not a guaranteeing subsidiary"

7.4 Clause 3 of the Amendment inserts changes to Clause 7 of the Second Schedule of the Regulations "Summary of Financial Statements".

Clause 7(3)(a):

(A) The existing subparagraph (iv) to be revoked and substituted by:

"(iv) The net profit or loss before taking account of taxation and extraordinary items and, if the equity method of accounting has been used pursuant to subclause (6) of this clause, before taking account of any profit or loss that has resulted from using that method:"

The purpose of this substitution is to ensure that the summary statements disclose profit or loss before taxation, extraordinary items and the inclusion of any amount for the equity accounted profit or loss of the NGS.

(B) The existing subparagraph (vi) to be revoked and substituted by:

"(vi) The net profit or loss before taking account of extraordinary items and, if the equity method of accounting has been used pursuant to subclause (6) of this clause, before taking account of any profit or loss that has resulted from using that method:"

and:

"(via) If the equity method of accounting has been used pursuant to subclause (6) of this clause, the profit or loss that has resulted from using that method:"

The purpose of these amendments is:

(i) to provide that the profit or loss of the borrowing group after tax, but before taking account of extraordinary items or the effect of equity accounting for the investments in NGS, is disclosed; and

(ii) that any profit or loss derived by the use of the equity method is separately disclosed;

in the prospectus.

(C) The existing subparagraph (viii) to be revoked and substituted by:

"(viii) The net profit or loss after taking account of extraordinary items and, if the equity method of accounting has been used pursuant to subclause (6) of this clause, including net profit or loss that has resulted by using that method;"

This is a consequential amendment.

(D) Subparagraph (xi) to be revoked and substituted by:

"(xi) Profit or loss retained in the group distinguishing the profit or loss derived by the equity method of accounting, where applicable, from all other profit or loss."

The purpose of this amendment is to ensure that the element of profit or loss retained by the borrowing group, which is attributable to the application of equity accounting to the investments in NGS, is separated out from other profit or loss retained in the borrowing group.

7.5 Clause 7(6):

This subclause to be revoked and substituted by:

"(6) "The statements referred to in this clause, except to the extent that they relate to the amount of investments of the group in, or profits or losses derived by the group from, non-guaranteeing subsidiaries, shall not include any amounts derived by using the equity method of accounting."

The purpose of this amendment is maintain the prohibition on the use of the equity method of accounting for investments by the borrowing group in any body other than non-guaranteeing subsidiaries.

7.6 Clause 4 of the Amendment amends Clause 17 of the Second Schedule "Capital and Reserves".

Clause 17(c):

This paragraph to be revoked and substituted by:

"(c) The nature and amount of each capital and revenue reserve (showing separately the amount of reserves or other surpluses arising from any revaluation of assets and any interests the group has in the reserves of non-guaranteeing subsidiaries) and the amount of retained earnings (showing separately any interests the group has in the retained earnings of non-guaranteeing subsidiaries); and details of changes in each reserve and in retained earnings since the commencement of the most recently completed accounting period of the group, showing separately the changes attributable to any interests the group has in the reserves or retained earnings of non-guaranteeing subsidiaries, (other than such details as are set out elsewhere in the registered prospectus)."

The purpose of this amendment is to provide for the inclusion of the group's share of any post-acquisition reserves or retained earnings of the NGS in its financial statements while also ensuring those amounts are separately disclosed.

7.7 Clause 5 of the Amendment amends Clause 24 of the Second Schedule "Investments".

Clause 24

This clause to be revoked and substituted by:

"24 **Investments** - (1) Each balance sheet required by clause 16 of this Schedule, or notes to that balance sheet which are set out in the registered prospectus, shall state -

"(a) The aggregate amount of investments; and

"(b) In addition (as separate items), the amounts included with that aggregate amount in respect of:

"(i) The total of investments in non-guaranteeing subsidiaries determined on the basis of the equity value of such subsidiaries or market value (if ascertainable), whichever is the lesser:

"(ii) The total of investments in related bodies corporate (other than non-guaranteeing subsidiaries) at cost (less amounts written off) or market value (if ascertainable), whichever is the lesser:

"(iii) The total of investments in associated bodies corporate at cost (less amounts written off) or market value (if ascertainable), whichever is the lesser:

"(iv) Where material, the total of securities issued by the Crown or a local authority; and, where this amount is not market value, the total market value:

"(v) Where material, the total of investments in other bodies corporate listed on a trading exchange and, where this amount is not market value, the total market value.

"(2) For the purposes of subclause (1)(b)(i) of this clause, "equity value" means the amount of the assets of a non-guaranteeing subsidiary less the amount of the liabilities of that subsidiary as disclosed in the financial statements for the most recently completed accounting period of the subsidiary."

The purpose of this amendment is to remove the reference to "cost (less amounts written off)" as one of the primary determinants of the carrying value of investments in NGS as recorded in the financial statements of borrowing groups, and to substitute for it the "equity value". Equity value is defined as the difference between the amount of the assets and the amount of the liabilities of a subsidiary as disclosed in the financial statements of the subsidiary. As such it accords with the measurement of "equity" as defined in the Statement of Concepts For General Purpose Financial Reporting issued recently by the New Zealand Society of Accountants ("NZSA").

7.8 This valuation basis differs from that used in the "Equity Method" of accounting as described in the Statements of Standard Accounting Practice of the NZSA because it does not permit the inclusion, in the carrying value of the investment, of the amount of any unamortised goodwill arising from the purchase of the particular subsidiary or subsidiaries.

7.9 Clause 6 of the Amendment amends Clause 28 of the Second Schedule "Contents of Profit and Loss Account". The general purpose of the amendments to this clause is to provide for the separate inclusion and disclosure of any profits or losses arising from applying the equity method of accounting to profits or losses arising from the group's investments in NGS.

7.10 Disclosures are constrained. The amendments do not change the focus of the statements away from the (borrowing) group. For example, subclause 28(a), requiring the disclosure of sales revenue, does not permit the profit and loss account in the prospectus to include sales revenues for the total issuing group. The only sales revenues which can be included in this statement are those for the companies in the (borrowing) group.

7.11 <u>Clause 28(b)</u>:

Subparagraph (b)(i) to be revoked and substituted by:

> "(i) <u>Non-guaranteeing</u> Subsidiaries <u>in the form of dividends received or receivable:</u>"

The purpose of this amendment is to ensure that only dividends paid or declared by NGS may be included "above the line" in the profit and loss accounts of borrowing groups. Equity accounted profits have to be separated from other profits.

7.12 <u>Clause 28(k)</u>:

Paragraph (k) to be revoked and substituted by:

"(k) The net profit or loss before taxation and, if the equity method of accounting has been used pursuant to clause 32 of this Schedule, before net profit or loss that has resulted from using that method:":

7.13 Clause 28(m)

Paragraph (m) to be revoked and substituted by:

"(m) The net profit or loss after taking account of taxation and before taking account of the matters specified in paragraph (n) of this clause and, if the equity method of accounting has been used pursuant to clause 32 of this Schedule, before taking account of net profit or loss that has resulted from using that method.

The purpose of this amendment is to provide separate disclosure of the net profit or loss after taxation but before any equity accounted profits or extraordinary items.

7.14 Clause (ma):

A new paragraph to be inserted after (m) to say:

"(ma) If the equity method of accounting has been used in term of clause 32 of this Schedule, the profit or loss that has resulted from using that method:"

The purpose of this new subclause is to provide that any profits or losses resulting from the application of the equity method of accounting are separately disclosed.

7.15 Clause 28(o):

Paragraph (o) to be revoked and substituted by:

"(o) The net profit or loss after taking account of taxation and the matters specified in paragraph (n) of this clause and, if the equity method of accounting has been used pursuant to clause 32 of this Schedule, including the net profit or loss that has resulted from using that method:".

This is a consequential amendment.

7.16 Clause 7 of the Amendment amends Clause 32 of the Second Schedule "Equity Method of Accounting"

Clause 32 to be revoked and substituted by:

"32 The balance sheets, profit and loss accounts, notes, and statements referred to in clauses 16 to 31 of this Schedule shall not, <u>except to the extent that they relate to the amount of investments in, or the amount of profits or losses derived from, or the share of the reserves of or retained earnings of, non-guaranteeing subsidiaries,</u> include any amounts derived by using the equity method of accounting."

The purpose of this amendment is to maintain the prohibition on the use of equity accounting for all purposes other than insofar as the financial statements in prospectuses relate to investments in or income derived from or the share of reserves or retained profits of the NGS. In particular this clause maintains the prohibition on equity accounting for investments in associated bodies corporate.

7.17 Clause 8 of the Amendment inserts new Clauses 32A and 32B and the heading "Financial Information Relating to Non-Guaranteeing Subsidiaries" in the Second Schedule.

7.18 <u>Clause 32A</u>:

A new clause to be included in the Second Schedule to qualify the application of the succeeding clause 32B. The clause says:

<u>"32A Application of clause 32B - Clause 32B of this Schedule shall apply only if, prior to or during the period to which the financial statements included in the prospectus pursuant to clauses 16 to 32 of this Schedule relate, a non-guaranteeing subsidiary carried on business and -</u>

<u>"(a) Acquired an asset; or</u>

<u>"(b) Incurred a debt."</u>

The clause limits the occasions on which disclosures are required in relation to non-guaranteeing subsidiaries to situations where an issuer has active non-guaranteeing subsidiaries.

7.19 Clause 32B

A new clause 32B to be added to the Second Schedule for the purpose of specifying the information to be included in the registered prospectus to provide the prospective investor with an appreciation of the composition of and significance of the group's investments in its NGS.

7.20 The new clause comprises several subclauses:

Clause 32B(1):

"(1) A statement setting out, with respect to the non-guaranteeing subsidiaries of the group, for the same accounting periods for which balance sheets have been included in the prospectus as required by clauses 16 and 30 of this Schedule, the aggregate of:

(a) Capital and reserves;

(b) Capital and reserves attributed to equity securities that are not held by members of the group;

(c) Term liabilities;

(d) Current liabilities;

(e) Total liabilities and capital;

(f) Material commitments for capital expenditure;

(g) Material commitments in respect of leases and hire purchase agreements;

(h) Material contingent liabilities;

(i) Fixed assets;

(j) Investments;

(k) Current Assets;

(l) Intangible and other assets;

(m) Total Assets."

The purpose of this subclause is to specify the level of detail required to be disclosed by issuers of debt securities about the size and composition of assets of their NGS.

7.21 Clause 32B(2)

"(2) A statement setting out, with respect to the non-guaranteeing subsidiaries of the group, for the same accounting periods for which profit and loss accounts have been included in the prospectus as required by clauses 27 and 30 of this Schedule, the aggregate of:

(a) Sales or other gross operating revenue;

(b) Investment income;

(c) Financing costs;

(d) Net profit or loss before taxation;

(e) The amounts provided for, or credited by way of, taxation;

(f) Net profits or losses after taking account of taxation and before extraordinary items;

(g) The amounts of extraordinary items;

(h) The net profits or losses after taxation and extraordinary items;

(i) Minority interests in the net profits or losses;

(i) The amounts of dividends paid and payable."

The purpose of this subclause is to specify the level of detail which has to be disclosed by issuers of debt securities about the level and composition of the earnings of the group's NGS.

7.22 Clause 32B(3)

"(3) A statement setting out, with respect to the non-guaranteeing subsidiaries, for the same balance dates for which audited financial statements and any interim financial statements have been included in the prospectus:

(a) the combined aggregate amount owed by those subsidiaries to the group, distinguishing between current liabilities and term liabilities;

(b) the combined aggregate amount owed to those subsidiaries by members of the group, distinguishing between current assets and other assets.

The purpose of this requirement is to provide that the level of financial exposure by the borrowing group to the NGS is separately disclosed, as is the exposure by the NGS to the borrowing group.

7.23 Clause 32B(4)

"(4) A statement reconciling:

(a) the combined aggregate amount of the capital and reserves of the non-guaranteeing subsidiaries, referred to in paragraph (a) of subclause (1) of this clause, less the amounts attributed to equity securities that are not held by members of the group, referred to in paragraph (b) of subclause (1) of this clause; with

(b) the amount of investments in non-guaranteeing subsidiaries referred to in clause 24(1)(b)(i) of this Schedule and disclosed in the audited consolidated balance sheet and any consolidated interim balance sheet included in the prospectus;

accompanied by a brief explanation of the reasons for any material differences between the respective amounts."

The purpose of this requirement is to provide a reconciliation of any differences between the aggregate of the NGS' stated value of capital and reserves (or equity value) and the amount at which these investments are recorded in the financial statements of the group.

7.24 Clause 32B(5):

"(5) A statement, in conjunction with the information disclosed pursuant to subclauses (1) to (4) of this clause, to the effect that this information with respect to the non-guaranteeing subsidiaries of the issuer is included in the prospectus to provide prospective investors with an indication of the composition and significance of the business activities carried on by, and the profits or losses contributed by, those companies which are subsidiaries of the issuer but which do not guarantee the repayment of the securities being offered or the payment of interest."

This statement is included to explain to prospective investors the significance of the information being included in the prospectus which relates to the group's NGS.

7.25 Clause 9 of the Amendment amends Clause 36 of the Second Schedule "Auditor's Report".

Clause 36(1)(b):

This paragraph to be amended by omitting the expression "and 12" and substituting the expression "12, 32B(1), 32B(2), and 32B(3)":

This amendment requires the auditor to comment on whether the information disclosed in the prospectus about the NGS has been taken from audited financial statements, and whether it has been correctly taken. The paragraph does not require the information relating to NGS to be audited.

7.26 Clause 10 of the Amendment covers the application of the new requirements. It is proposed that nothing in the Amendment should apply to a registered prospectus registered before the close of the 31st day of August 1994 or to any advertisement that relates to any debt securities offered to the public for subscription by means of any such prospectus.

INVITATION

In terms of section 70(3) of the Securities Act 1978 the Commission invites submissions from interested parties on the proposals for amendments to the Securities Regulations 1983 outlined in this memorandum.

All submissions should be in writing and should be forwarded to the Commission at the following address by 25 February 1994 -

The Chief Executive
Securities Commission
P.O. Box 1179
WELLINGTON Facsimile: 472-8076

P.D. McKenzie
Chairman

6 December 1993

Footnotes

1. (1991) 5 NZCLC 66903

2. Requirements for Debt Security Prospectuses - Securities Regulations 1983 - Accounting for Investments of the Borrowing Group in Non-Guaranteeing Subsidiaries - A Discussion Paper. Issued by the Securities Commission February 1992.

APPENDIX A

SUBMISSIONS WERE RECEIVED ON THE COMMISSION'S DISCUSSION PAPER FROM THE FOLLOWING PARTIES:

ANZ Banking Group (New Zealand) Limited

Bank of New Zealand (per Buddle Findlay)

Hongkong and Shanghai Banking Corporation Limited

Reserve Bank of New Zealand

AA Finance Limited

New Zealand Stock Exchange

Financial Services Federation

Buttle Wilson & Co. Limited

Australian Mutual Provident Society

Ernst and Young

Deloitte Ross Tohmatsu

Coopers and Lybrand

New Zealand Law Society (Commercial and Business Law Committee)

P.E. Ratner (Rudd Watts and Stone - Personal View)

Simpson Grierson Butler White

Trustee Corporations Association of New Zealand

Bell Gully Buddle Weir

FPG Research Limited

Independent Newspapers Limited

New Zealand Society of Accountants (Company and Securities Law Committee)

Dr O. Bauer, Consultant

APPENDIX B

THE SECURITIES REGULATIONS 1983,

AMENDMENT NO. 3

Governor-General

ORDER IN COUNCIL

At Wellington this day of 1993

Present:

IN COUNCIL

PURSUANT to section 70(1) of the Securities Regulations 1983, Her Excellency the Governor-General, acting by and with the advice and consent of the Executive Council, and in accordance with a recommendation of the Securities Commission, hereby makes the following regulations.

REGULATIONS

1. Title and commencement - (1) These regulations may be cited as the Securities Regulations 1983, Amendment No. 3, and shall be read together with and deemed part of the Securities Regulations 1983* (hereinafter referred to as the principal regulations).

(2) These regulations shall come into force on the 1st day of September 1994.

2. Interpretation - Regulation 2(1) of the principal regulations is hereby amended by inserting, after the definition of the term "monetary assets", the following definition:

"'Non-guaranteeing subsidiary' means any subsidiary of an issuer that is not a guaranteeing subsidiary:".

3. Amendments to clause 7 of Second Schedule - (1) Clause 7(3)(a) of the Second Schedule to the principal regulations is hereby amended -

(a) By revoking subparagraph (iv), and substituting the following subparagraph:

"(iv) The net profit or loss before taking account of taxation and extraordinary items and, if the equity method of accounting has been used pursuant to subclause (6) of this clause, before taking account of any profit or loss that has resulted from using that method:

(b) By revoking subparagraph (vi), and substituting the following subparagraphs:

"(vi) The net profit or loss before taking account of extraordinary items and, if the equity method of accounting has been used pursuant to subclause (6) of this clause, before taking account of any profit or loss that has resulted from using that method:

"(via) If the equity method of accounting has been used pursuant to subclause (6) of this clause, the profit or loss that has resulted from using that method:":

(c) By revoking subparagraph (viii), and substituting the following subparagraph:

"(viii) The net profit or loss after taking account of extraordinary items and, if the equity method of accounting has been used pursuant to subclause (6) of this clause, including net profit or loss that has resulted by using that method:":

(d) By revoking subparagraph (xi), and substituting the following subparagraph:

"(xi) Profit or loss retained in the group distinguishing the profit or loss derived by the equity method of accounting, where applicable, from all other profit or loss."

(2) Clause 7 of the Second Schedule to the principal regulations is hereby amended by revoking subclause (6), and substituting the following subclause:

"(6) The statements referred to in this clause, except to the extent that they relate to the amount of investments of the group in, or profits or losses derived by the group from, non-guaranteeing subsidiaries, shall not include any amounts derived by using the equity method of accounting."

4. **Amendment to clause 17 of Second Schedule** - Clause 17 of the Second Schedule to the principal regulations is hereby amended by revoking paragraph (c), and substituting the following paragraph:

"(c) The nature and amount of each capital and revenue reserve (showing separately the amount of reserves or other surpluses arising from any revaluation of assets and any interests the group has in the reserves of non-guaranteeing subsidiaries) and the amount of retained earnings (showing separately any interests the group has in the retained earnings of non-guaranteeing subsidiaries); and details of changes in each reserve and in retained earnings since the commencement of the most recently completed accounting period of the group, showing separately the changes attributable to any interests the group has in the reserves or retained earnings of non-guaranteeing subsidiaries, (other than such details as are set out elsewhere in the registered prospectus)."

5. **New clause 24 of Second Schedule substituted** - The Second Schedule to the principal regulations is hereby amended by revoking clause 24, and substituting the following clause:

"24. Investments - (1) Each balance sheet required by clause 16 of this Schedule, or notes to that balance sheet which are set out in the registered prospectus, shall state -

"(a) The aggregate amount of investments; and

"(b) In addition (as separate items), the amounts included within that aggregate amount in respect of:

"(i) The total of investments in non-guaranteeing subsidiaries determined on the basis of the equity value of such subsidiaries or market value (if ascertainable), whichever is the lesser:

"(ii) The total of investments in related bodies corporate (other than non-guaranteeing subsidiaries) at cost (less amounts written off) or market value (if ascertainable), whichever is the lesser:

"(iii) The total of investments in associated bodies corporate at cost (less amounts written off) or market value (if ascertainable), whichever is the lesser:

"(iv) Where material, the total of securities issued by the Crown or a local authority; and, where this amount is not market value, the total market value:

"(v) Where material, the total of investments in other bodies corporate listed on a trading exchange and, where this amount is not market value, the total market value.

"(2) For the purposes of subclause (1)(b)(i) of this clause, "equity value" means the amount of the assets of a non-guaranteeing subsidiary less the amount of the liabilities of that subsidiary as disclosed in the financial statements for the most recently completed accounting period of the subsidiary."

6. **Amendments to clause 28 of Second Schedule** - Clause 28 of the Second Schedule to the principal regulations is hereby amended -

(a) By revoking subparagraph (i) of paragraph (b), and substituting the following subparagraph:

"(i) Non-guaranteeing subsidiaries in the form of dividends received or receivable:":

(b) By revoking paragraph (k), and substituting the following paragraph:

"(k) The net profit or loss before taxation and, if the equity method of accounting has been used pursuant to clause 32 of this Schedule, before net profit or loss that has resulted from using that method:":

(c) By revoking paragraph (m), and substituting the following paragraphs:

"(m) The net profit or loss after taking account of taxation and before taking account of the matters specified in paragraph (n) of this clause and, if the equity method of accounting has been used pursuant to clause 32 of this Schedule, before taking account of net profit or loss that has resulted from using that method:":

"(ma) If the equity method of accounting has been used pursuant to clause 32 of this Schedule, the profit or loss that has resulted from using that method:":

(d) By revoking paragraph (o), and substituting the following paragraph:

"(o) The net profit or loss after taking account of taxation and the matters specified in paragraph (n) of this clause and, if the equity method of accounting has been used pursuant to clause 32 of this Schedule, including the net profit or loss that has resulted from using that method:".

7. **New clause 32 of Second Schedule substituted** - The Second Schedule to the principal regulations is hereby amended by revoking clause 32, and substituting the following clause:

"32. The balance sheets, profit and loss accounts, notes, and statements referred to in clauses 16 to 31 of this Schedule shall not, except to the extent that they relate to the amount of investments in, or the amount of profits or losses derived from, or the share of the reserves of or retained earnings of, non-guaranteeing subsidiaries, include any amounts derived by using the equity method of accounting."

8. New heading and clause inserted in Second Schedule - The Second Schedule to the principal regulations is hereby amended by inserting after clause 32, the following heading and clauses:

"Financial Information Relating
to Non-Guaranteeing Subsidiaries

"32A. Application of clause 32B - Clause 32B of this Schedule shall apply only if, before the specified date, a non-guaranteeing subsidiary has commenced business and -

"(a) Has acquired an asset; or

"(b) Has incurred a debt.

"32B. Financial information relating to non-guaranteeing subsidiaries - (1) A statement setting out, with respect to non-guaranteeing subsidiaries of the group, for the same accounting periods for which balance sheets have been included in the prospectus as required by clauses 16 and 30 of this Schedule, the aggregate of :

"(a) Capital and reserves:

"(b) Capital and reserves attibuted to equity securities that are not held by members of the group:

"(c) Term liabilities:

"(d) Current liabilities:

"(e) Total liabilities and capital:

"(f) Material commitments for capital expenditure:

"(g) Material commitments in respect of leases and hire purchase agreements:

"(h) Material contingent liabilities:

"(i) Fixed assets:

"(j) Investments:

"(k) Current assets:

"(l) Intangible and other assets:

"(m) Total assets.

"(2) A statement setting out, with respect to non-guaranteeing subsidiaries of the group, for the same accounting periods for which profit and loss accounts have been included in the prospectus as required by clauses 27 and 30 of this Schedule, the aggregate of:

"(a) Sales or other gross operating revenue:

"(b) Investment income:

"(c) Financing costs:

"(d) The net profits or losses before taxation:

"(e) The amounts provided for, or credited by way of, taxation:

"(f) The net profits or losses after taking account of taxation and before extraordinary items:

"(g) The amounts of extraordinary items:

"(h) The net profits or losses after taxation and extraordinary items:

"(i) Minority interests in the net profits or losses:

"(j) The amounts of dividends paid and payable.

"(3) A statement setting out, with respect to non-guaranteeing subsidiaries of the group, for the same balance dates for which audited financial statements and any interim financial statements have been included in the prospectus:

"(a) The combined aggregate amount owed by those subsidiaries to the group, distinguishing between current liabilities and term liabilities:

"(b) The combined aggregate amount owed to those subsidiaries by members of the group, distinguishing between current assets and other assets.

"(4) A statement reconciling -

"(a) The combined aggregate amount of the capital and reserves of the non-guaranteeing subsidiaries referred to in paragraph (a) of subclause (1) of this clause, less the amounts attributed to equity securities that are not held by members of the group referred to in paragraph (b) of subclause (1) of this clause; with

"(b) The amount of investments in non-guaranteeing subsidiaries referred to in clause 24(1)(b)(i) of this Schedule and disclosed in the audited consolidated balance sheet and any consolidated interim balance sheet included in the prospectus -

accompanied by a brief explanation of the reasons for any material differences between the respective amounts.

"(5) A statement in conjunction with the information disclosed pursuant to subclauses (1) to (4) of this clause to the effect that the information with respect to the non-guaranteeing subsidiaries of the issuer is included in the prospectus to provide prospective investors with an indication of the composition and significance of the business activities carried on by, and the profits or losses contributed by, those companies which are subsidiaries of the issuer but which do not guarantee the repayment of the securities being offered or the payment of interest."

9. Amendment to clause 36 of Second Schedule - Clause 36(1)(b) of the Second Schedule to the principal regulations is hereby amended by omitting the expression "and 12", and substituting the expression "12, 32B(1), 32B(2), and 32B(3)".

10. Application to existing prospectuses - Nothing in these regulations applies to a registered prospectus registered before the close of the 31st day of August 1994 or to any advertisement that relates to any debt securities offered to the public for subscription by means of any such prospectus.

Clerk of the Executive Council.

EXPLANATORY NOTE

This note is not part of the regulations, but is intended to indicate their general effect.

These regulations, which come into force on 1 September 1994, make a number of related amendments to the Second Schedule to the Securities Regulations 1983. The Second Schedule prescribes the information that must be contained in a registered prospectus containing offers of debt securities.

The amendments to clause 7 (which relates to the summary financial statement of the borrowing group) will allow financial information to be included for non-guaranteeing subsidiaries on the basis of the equity method of accounting if it is separately disclosed.

The amendment to clause 17 will require disclosure of the borrowing groups' share of retained earnings and reserves of its non-guaranteeing subsidiaries.

The amendment to clause 24 will allow investments in non-guaranteeing subsidiaries to be shown at the lesser of their equity value (as that term is defined) or market value instead of at the lesser of cost or market value which is the present requirement.

The amendments to clause 28 will allow the profit and loss account to include profits or losses for non-guaranteeing subsidiaries on the basis of the equity method of accounting if they are separately disclosed.

The present clause 32 prohibits the use of the equity method of accounting in relation to the financial statements included in a registered prospectus. The new clause 32 will permit the use of the equity method of accounting but only in relation to non-guaranteeing subsidiaries.

The new clauses 32A and 32B prescribe information relating to non-guaranteeing subsidiaries that must be included in a registered prospectus.