# Restrictive covenants and accounting principles in trust deeds governing convertible unsecured note issues in Australia

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# RESTRICTIVE COVENANTS AND ACCOUNTING PRINCIPLES IN TRUST DEEDS GOVERNING CONVERTIBLE UNSECURED NOTE ISSUES IN AUSTRALIA

A report submitted to the School of Accountancy, University of New South Wales in partial fulfilment of the requirements of the degree of Master of Commerce (Honours).


by

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1987

I hereby declare that this submission is my own work and that, to the best of my knowledge and belief, it contains no material previously published or written by another person nor material which to a substantial extent has been accepted for the award of any other degree or diploma of a university or other institute of higher learning, except where due acknowledgement is made in the text.

TAY KOK LEONG
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## ABSTRACT

This study extends Whittred & Zimmer (1986) by examining a large sample of convertible note trust deeds issued by Australian listed companies. The sample examined includes those executed subsequent to the period surveyed by Whittred & Zimmer.

The study reviews the statutory and Australian Associated Stock Exchange regulations governing the issues of convertible notes to ascertain the extent to which negotiable covenants and accounting principles written into these trust deeds were based on regulations. The study found that there were regulatory requirements for certain covenants but there was scope for negotiation within these requirements.

The study provides evidence of the nature of the restrictive covenants that were contained in the convertible note trust deeds and of the negotiated accounting principles utilised in the monitoring of the borrowing limitation constraints. These negotiated accounting principles are compared with the accounting standards in place in Australia. In contrast with Whittred & Zimmer (1986), the study found that the negotiated accounting principles only modified three of the mandated accounting standards in place. The differences between the results of the two studies mainly reflects a difference in interpretation of what constitutes a modification to an accounting standard.

The study also examines the time series effect of the introduction of new accounting standards on the negotiated accounting principles. There was no evidence of any major accounting standard induced adjustments in the convertible note trust deeds surveyed.

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# 1 INTRODUCTION

Debt agreements are a group of formal contracts between the firm and the debtholders. Studies such as those by Smith & Warner (1979), Leftwich (1983) and Whittred & Zimmer (1986) have provided evidence on the nature of the restrictive covenants written into debt agreements and of the accounting information utilised in the monitoring of the covenants. These restrictive covenants are described as negotiated covenants to control the conflicts of interest between debtholders and shareholders/managers by restricting the extent to which shareholders/managers can engage in opportunistic behaviour for their own benefit at the expense of the debtholders. Such evidence has facilitated the generation and testing of hypotheses on accounting procedure variation across firms and industries and about procedure changes and their stock price effects (1) [Watts & Zimmerman 1986, p 200].

Smith & Warner (1979) examined the bonding covenants written into debt agreements in the U.S.A. They observed that these restrictive covenants are often written in terms of accounting variables and make use of numbers published in the financial statements. Smith & Warner (1979, p 144) concluded that the covenants frequently do not specify how the accounting numbers in the financial statements are to be computed and hence restrictions on opportunistic behaviour can be relaxed by manipulating the accounting numbers which define the constraints.

Leftwich (1983) analysed the accounting information in debt contracts in the U.S.A. and observed that the definitions of the accounting numbers consistently refer to generally accepted accounting principles [hereafter referred as GAAP] but are systematically adjusted by negotiated modifications. Leftwich (1983, p 23) defined GAAP as the regulated set of accounting measurement rules promulgated by accounting regulatory bodies. The definitions of accounting numbers in the lending agreements required that contractual accounting numbers be determined based on GAAP in force on the date of calculation with negotiated modifications taking the form of bottom-line adjustments rather than a complete recalculation of the accounting numbers. Leftwich further observed systematic differences between negotiated accounting measurement rules in lending agreements and GAAP and suggested that the observed negotiated rules are generally consistent with the hypothesis that the rules reduce the conflicts of interest between debtholders and shareholders. He also suggested that the existence of systematic differences in negotiated rules is indicative of a demand for a diverse set of accounting rules and consequently that it is unlikely that a unique set of rules can be mandated without imposing costs on at least some users of accounting numbers.

In Australia, Whittred & Zimmer (1986) examined the trust deeds governing public debt issues by Australian industrial and commercial companies and observed cross-sectional variation in the restrictive covenants related to the nature of the debt issues. Specifically, debenture trust deeds imposed tighter borrowing restrictions than either convertible note or unsecured note trust deeds. Whittred & Zimmer (1986, p 27) have further suggested that constraints in convertible note trust deeds are generally less stringent than those under the debenture and unsecured note trust deeds in terms of the definition of the accounting terms being used to measure the limitation constraints. Comparing the negotiated accounting rules with the 14 Statements of Australian Accounting Standards [hereafter AAS standards] in place and the exposure drafts of proposed standards in issue at the time of their study, they observed that the measurement of defined accounting variables under the Australian deeds is similar to that observed by Leftwich (1983, p 23). The audited accounts drawn up in accordance with `usual accounting practices' prevailing at the date of calculation is used in the first instance with negotiated modifications then made as bottom-line adjustments. These adjustments are generally made to reduce the ability of management to relax restrictive covenants [Whittred & Zimmer 1986, p 30]. In respect of those items permitted to be measured in accordance with `usual accounting practice', they suggested that management has a considerable amount of discretion in its choice of accounting techniques. They observed that the only substantive contractual constraints on this discretion are the systematic deductions from total tangible assets and the power of the auditors to make discretionary adjustments.

Two Australasian studies predate Whittred & Zimmer (1986). First, Emanuel (1976) reviewed the restrictive covenants written into 27 debenture trust deeds issued by New Zealand companies and observed systematic differences in the level of borrowing permitted across industries. Furthermore, finance companies and property companies generally had less restrictive limits. The borrowing constraints were found to be based on balance sheet figures and since the balance sheet figures were based on the historical cost-based accounting method, there was considerable flexibility available to companies in the selection of accounting principles. Emanuel (1976, pp 30, 39) concluded that the negotiated measure of borrowing limitation would probably prove unsatisfactory for protection of investors.

The second study was made by Armitage (1981) who reviewed, from a legal perspective, the Australian debenture trust deeds and the borrowing limitations contained therein. He examined the definition of the borrowing limitation clauses and observed two classes of adjustments - those whose functions might be described as discriminatory, i.e. to exclude amounts included in the balance sheet which represent `suspect' assets or are otherwise inappropriate for borrowing limitation purposes, those whose function is to `update' the balance sheet amounts and the discriminatory adjustments where the determination of the amount of the particular borrowing limitation element is being made as at a date other than the actual balance sheet date [Armitage 1981, p 68]. The `suspect' assets were those assets relating to investments in and advances to non-guarantor companies. These assets were viewed as suspect because of the experience of the major company failures in the 1960's. Armitage observed the change in definition of the borrowing limitation from that computed based on the company and the guarantors to that based on the company and subsidiaries in convertible note trust deeds. He suggested that this change in basis of computation was not in the interest of debtholders.

## 1.1 Aims and Significance of the Study

This study extends Whittred & Zimmer (1986) by examining in greater detail a larger sample of convertible note trust deeds including those executed subsequent to the period of the Whittred & Zimmer study. Whittred & Zimmer (1986) examined 62% of debenture trust deeds, 64% of unsecured note trust deeds and only 30% of convertible note trust deeds governing public debt issues over the period 1972 to 1983. The trust deeds examined by them were executed between October 1962 and August 1982.

The aims in extending the Whittred & Zimmer study are:

a) to examine the restrictive covenants written into an extended (in terms of size and time period) sample of convertible note trust deeds to provide insights into the nature of the bonding arrangements contained in these trust deeds and then to compare them with those reported by Whittred & Zimmer;

b) to assess the degree of correspondence between negotiated accounting principles in the convertible note trust deeds with the accounting standards in place in Australia, i.e. the AAS standards, ASRB standards and exposure drafts of proposed standards; and

c) to examine the impact of the introduction of new accounting standards on the negotiation of accounting principles in the convertible note trust deeds.

An increased understanding of the nature of restrictive covenants in convertible note trust deeds and of the accounting principles incorporated therein, can assist in reducing the construct validity threat in future empirical studies that examine a firm's choice of accounting methods and its reactions to the issue of new accounting standards. The study assists in identifying the features of the debt contracts that are likely to influence a firm's choice of accounting policies and its lobbying behaviour in relation to changes in accounting standards (including the issue of new standards) .

The study is considered to be significant for another reason. The inclusion of the convertibility option in debt contracts is one of the bonding measures which serves to align the interests of debtholders with shareholders [Smith & Warner 1979]. However, there is evidence that the share prices of companies announcing issues of convertible securities suffer a significant negative decline while no similar impact is associated with the issue of straight debt [Eckbo 1986]. Little is known of the reason for this differential impact and of the reason why managers persist voluntarily to undertake such wealth reducing actions by issuing convertible notes. Knowledge of the differences in the nature of the restrictive covenants between convertible note contracts and straight debt contracts could be relevant to studies examining incentives of firms to issue convertible notes and to studies examining the differential market price reaction to the debt issues.

Finally, information about the degree of correspondence of negotiated accounting principles with Australian accounting standards provides evidence on the adequacy or application of these standards in the debt market.

## 1.2 Outline of the Study

Section 2 provides background information on institutional and regulatory influences on convertible note issues in Australia to ascertain the extent to which restrictive covenants and accounting rules contained therein are statutorily or Australian Associated Stock Exchange (AASE) determined. Section 3 reports the results of the analysis of the restrictive covenants and negotiated accounting principles in the trust deeds examined, while the comparison of the findings with Whittred & Zimmer (1986) is described in section 4. A summary and conclusions are contained in section 5.

## 2 REGULATORY CONTROL OVER CONVERTIBLE NOTE ISSUES

This section examines the history of convertible note issues in Australia and therein regulatory controls over the issues. The objective of this section is to assess the extent to which regulatory requirements determine the covenants and accounting principles in convertible note trust deeds.

### 2.1 Nature of Convertible Notes

A convertible note is a financial security which possesses some characteristics of debt and of equity. It is issued with a fixed coupon rate of interest and maturity term. The holder of a convertible note has the option, exercisable at a specified time during the currency of the issue, to convert the note into equity shares at the predetermined rate of conversion. In Australia, unlike the United States, the tax regulations do not permit the issuing company to call on the convertible note during the currency of its term.

The use of convertible notes first became popular in the late 1950's. Their appeal arose mainly due to the tax deductibility of interest paid by issuing companies [Bird & Peirson 1973]. The widespread use of convertible notes instead of new share issues caused the Commonwealth Government to introduce legislation to disallow interest deductibility in November 1960, claiming that the motivation for switching to convertible notes was tax avoidance [s51AB Income Tax and Social Services Contribution Assessment Act 1960].

In late August 1970, the Commonwealth Government re-introduced legislation allowing tax deductibility of interest paid on convertible notes that comply with certain conditions. Some of these conditions were that the issue should be of a minimum of a 7 year term with the holder having the sole option to convert and that the issue price should not be less than the par value of the conversion entitlement or 90% of the market price of the equivalent shares at a date 6 weeks prior to the announcement of the offer of the convertible note issue. The notes must also not be issued with terms that offer the noteholders the inducement to advance the exercise of their option to convert [s82S Income Tax Assessment Act 1936].

In January 1976, the Commonwealth Government further relaxed the rules by removing the minimum 7 year term and allowing the company to nominate the periods during which conversion could be exercised. The holders of the convertible notes still had the sole option to convert. A further concession was that for domestic loan issues, the interest rate may be varied in line with the movement in the rate of interest applicable to a specified class of Government securities. However the notes could not be issued with terms that would induce the holders to postpone exercising their option to convert [s82SA Income Tax Assessment Act 1936].

In the early 1980s, several large placements were put on the market in response to institutional demands. A band-waggon effect occurred and a spate of issues flooded the market [Thomas 1986].

Apart from convertible notes being issued as consideration in a takeover, convertible notes are almost universally issued by way of rights entitlements to holders of existing company's securities with, in many cases, concurrent placements to selected private institutions through the underwriters [see section 3.1.2 below]. This form of issue does not amount to an issue to the public as defined by the Companies Act [s94(2) Companies Act 1981] and the issuing company, not being a borrowing corporation as defined by the Act [s5(1) Companies Act 1981], would not be subject to the obligations imposed on borrowing corporations under the Act. Whilst the Companies Act is concerned only with convertible notes issued by a borrowing corporation, the AASE regulations, which include some rules similar to the statutory requirements with respect to controls over borrowing corporations, do not differentiate between issues made to the public and to existing holders of company's securities [Definition section - Borrowing Company, AASE Official Listing Requirements, August 1986]. If the convertible note is listed, Stock Exchange regulations will have to be complied with [s42 Securities Industry Act 1981].

## 2.2 Regulatory controls

In the early 1960s, there were a series of large scale borrowing company failures [2] and Inspectors were appointed to investigate the affairs of several of these failures. Questionable accounting practices and non-adherence to accounting principles were highlighted in many of these reports. [3] The Inspectors' Reports on the Reid Murray Group [Interim Report on Reid Murray Group, p 20] and Stanhill Development Finance Ltd [Interim Report on Stanhill Development Group, p 57-59] drew attention to the widespread practice of on-lending on an unsecured basis by a borrowing corporation to non guarantor subsidiaries [4] and associated companies and to the undesirable consequences of such practices. Arising from these company failures, new legislative controls were introduced to safeguard the interests of the investing public. These controls were first introduced in the Victorian Companies (Public Borrowings) Act 1963, which amended the Victorian Companies Act 1961, and similar legislation in each of the other States followed. [5] Following the adoption of the Uniform Companies Act legislation [commonly known as the Uniform Companies Act [6] ] by the States in 1961 and 1962, the AASE undertook extensive revision of its listing requirements. In 1964, a revised "Listing Manual" was issued and it incorporated the changes introduced by the "Public

Borrowing Acts" [Urquhart 1964]. These statutory and AASE imposed controls are discussed below.

### 2.2.1 Statutory Regulation of Convertible Note Issues under the Companies Act

Statutory regulations governing public borrowings by companies were introduced principally as an aftermath of the company failures in the 1960s. The following review covers the legislative requirements in force as from 1961 when the Uniform Companies Act was first adopted by the States. The Uniform Companies Act was repealed and replaced by the Companies Act 1981 on 1 July 1982. In this section, the term `Companies Act', when used, refers to the Act for the time being in force and where the legislative provisions under both the Acts is similar, the Act referencing is only made to the current Companies Act 1981.(7)

Prior to 1964, the Uniform Companies Act only prescribed certain reporting requirements to be made in the prospectus for debenture (including convertible note) issues. In 1964, the Public Borrowings Act introduced the concept of a borrowing corporation and laid down some controls over the raising of funds by these companies and for the regular monitoring of their activities. These controls were incorporated into s74 - s74H of the Uniform Companies Act 1961 and have been incorporated with minor modifications, into the Companies Act 1981.

The Companies Act defines a debenture as including notes [s5(1) Companies Act 1981]. No definition of convertible note is given. The Companies (Acquisition of Shares) Act 1981, however, defines a convertible note as having the same meaning as in s3A of Part III of the Income Tax Assessment Act 1936. A convertible note is defined in s82(1) of the Income Tax Assessment Act 1936 as a note with a convertibility element. It therefore appears that a convertible note falls within the ambit of the definition of debenture under the Companies Act. Since 1964, the Companies Act has imposed specific obligations only on debentures issued by borrowing corporations. A borrowing corporation is a company that has invited the public to subscribe or purchase its debentures [s5(1) Companies Act 1981]. Issues made to existing shareholders or through stockbrokers are not deemed to be issues to the public [s94(2) Companies Act 1981].

There have been minor modifications to the statutory provisions governing debenture issues by borrowing corporations since the introduction of the Public Borrowings Act. A review of the statutory requirements is detailed below.

A) Prospectus for Issues

Prior to the introduction of the Public Borrowings Act in 1964, the prospectus in respect of debenture (including convertible note) issues had to contain a report by the auditors of the assets and liabilities of the borrowing company and the guarantor companies [para 20 Fifth Sch, Uniform Companies Act 1961]. The Public Borrowings Act made a distinction between debentures secured by mortgage and those secured by a floating charge and prescribed different reporting requirements in the prospectus for each type. In respect of debentures secured by a floating charge, the statement of the assets and liabilities of the borrowing company and the guarantor companies was modified to reflect the tangible assets available as security for the charge and, in particular:

to exclude

(i) uncharged assets,

(ii) intangible assets, including that part of the value of shares in subsidiary companies that are represented by intangible assets,

(iii) shares in and advances to non-guarantor companies, and

to include

(i) the aggregate amount of debentures to be raised under the prospectus.

[para 33(1b) Fifth Sch, Uniform Companies Act 1961]

In respect of debentures secured by mortgage, where total secured liabilities did not exceed 60% of the value of the company's or guarantor companies' interest in the land, no amendments to the statement were required. A statement stating the position of the security and a copy of the Valuation Report had to be included in the Prospectus [para 32, Fifth Sch, Uniform Companies Act 1961]. Where the secured liabilities exceeded the stated percentage, the reporting requirements, applicable for debentures secured by a floating charge, would apply [s38(5) Uniform Companies Act 1961].

**B) Obligations Of Borrowing Corporations**

**1) Trust Deed Covenants**

The issuing of debentures by a company as consideration for acquisition pursuant to a takeover scheme and by a borrowing corporation under a trust deed which does not contain the covenants required to be included by the Companies Act is an offence under the Act. The Companies Act requires that the trust deed shall contain a limitation on the amount that the borrowing corporation may borrow pursuant to that deed or those debentures and shall also contain covenants that the company will use its best endeavour to carry on and conduct its business in a proper and efficient manner, and that the company will make available to the trustee the accounting and other records and any information about those records which the trustee may require [s154(1) Companies Act 1981]. It imposes similar obligations on guarantor companies and requires that the trust deed contains these covenants [s154(2) Companies Act 1981]. Although the Companies Act requires a borrowing limitation to be placed on the debenture issue, there is no prescription as to how it is to be computed or what the limits should be. These matters are open to negotiation between the lender and the borrowing corporation.

2) Reporting Obligations

There are three different types of reporting obligations imposed by the Companies Act. First, the quarterly report by directors is designed to monitor compliance with the company's obligations under the trust deeds. Second, the trustees are also to be informed when any new charges are created. The third type of report is the report of the financial position of the company and this is achieved through the submission of financial accounts. Each of these reporting obligations is considered in more detail.

i) Quarterly Report

The directors of the borrowing corporation must submit quarterly reports within a month of the end of each reporting quarter to the trustee and file a copy with the Corporate Affairs Commission [s158(1) Companies Act 1981]. The content of the quarterly report is set out in the Companies Act and includes among other items, a statement as to whether the borrowing limitations have been exceeded and whether the covenants and provisions of the deed have been duly observed and performed by the borrowing company and guarantor companies [s158(2) Companies Act 1981]. The report is also to state whether there were any substantial changes in the nature of the business of the borrowing corporation and guarantor subsidiaries which were not previously reported and whether there are any matters adversely affecting the security or the interests of debenture holders. Changes in the status of guarantor subsidiaries, additional guarantors, a company ceasing to be guarantor or a guarantor company changing its name are to be reported [s158(3) Companies Act 1981]. The quarterly report must also state the progress that the borrowing corporation has made in achieving the purpose of completing the project for which the debenture money was raised [s160(1) Companies Act 1981]. Where the borrowing corporation has lent money or assumed a liability of any related company, details of such transactions are to be disclosed [s158(2) Companies Act 1981].

**ii) Reporting of Creation of Charges**

The borrowing corporation must furnish, in writing to the trustees within 21 days, particulars of any charges created. If the total amount to be advanced under the security is indeterminate, details must be furnished within 7 days after the advance is made, but where these advances are merged with a current account with a bank, inclusion in the quarterly report of the net amount outstanding in respect of the advance would suffice [s158(4) Companies Act 1981].

iii) **Submission of Financial Accounts**

The Companies Act imposes a duty on the directors of the borrowing corporation and each of the `relevant guarantor companies' to submit annual and half yearly accounts prepared in accordance with the requirements of the Companies Act and duly audited to the trustees and to the Commissioner of Corporate Affairs [s158(5) Companies Act 1981]. A `relevant guarantor company' is a guarantor subsidiary company that has been required by the trustee to submit the annual and half yearly accounts or a guarantor company that is not a subsidiary of the borrowing corporation [s158(23) Companies Act 1981]. The trustee may dispense with the requirement of audit in respect of the half yearly accounts [s158(19) Companies Act 1981] and may also exempt the relevant guarantor company from the requirement of submitting group accounts [s158(14) Companies Act 1981]. A borrowing corporation that is a holding company must, in addition, submit the consolidated accounts of the borrowing company and guarantor subsidiary companies [s158(6) Companies Act 1981]. Hence the financial accounts to be submitted would comprise the following:

i) accounts of the borrowing company,

ii) accounts of each of the relevant guarantor companies (if any),

iii) consolidated accounts of the borrowing company and all its subsidiaries, and

iv) consolidated accounts of the borrowing company and guarantor companies which are subsidiaries of the borrowing company.

[Note: subsidiaries of guarantor companies need not be consolidated.]

By way of summary, it is important to note that the above-mentioned statutory regulations apply only to borrowing corporations as defined by the Companies Act. Where the debenture issue is not deemed to be made to the public, the issuing company is not a borrowing corporation as defined by the Act and is not subject to these controls. Other than the borrowing limitation, the Companies Act does not impose any other restrictive covenants on a company issuing debentures.(8)

### 2.2.2 Australian Associated Stock Exchange Listing Requirements

Under the current AASE Listing Requirements definitions section, a convertible note is defined as an unsecured note convertible into shares by the holder. Prior to 1954, debentures and unsecured notes were not differentiated in the Official Listing Requirements of the AASE. An unsecured note first appeared as a separate item in September 1954 and was defined as a `document constituting either expressly or by implication, an acknowledgement of indebtedness of a company in respect of money borrowed by it but not secured by any mortgage or charge over all or any of the company's assets [Part E(1), Official Listing Requirements, Sept 1954]. The Listing Requirements also required that the the terms of issue of the unsecured notes shall be set out in a trust deed acceptable to the Committee of the Stock Exchange and a trustee or trustees must be appointed. A guideline note was incorporated into the Official Listing Requirements advising that the Committee may refuse to grant official quotation to an issue of unsecured notes where the trust deed permits the issuing of notes in excess of 1 and 1/2 times shareholders funds after deducting intangible assets. This constraint was not imposed on debenture issues.

By April 1956, the guidelines for granting of listing had been changed. The limitation of the amount of unsecured notes that the company could borrow was no longer applied. Instead, the Committee could refuse to grant official quotation to an issue unless the trust deed governing the issue provided that the issuing company shall not, without the previous sanction of an extra-ordinary resolution adopted by holders of not less than 75% of the notes outstanding, during the currency of the issue, incur liabilities including such notes in excess of an amount equal to 1 and 1/2 times of shareholders funds or provides that the total liabilities of the company during the same period shall not exceed 3/5 of total tangible assets of the company [Part E Official Listing Requirements, April 1956].

Convertible unsecured notes were first mentioned in the Official Listing Requirements in January 1958 where companies were required to state in the trust deed whether the convertible note holders were entitled to rights and bonus issues of shares.

On 20 June 1961, the Official Listing Requirements were amended to require certain additional disclosures by companies whose issues of unsecured notes were governed by trust deeds which permitted the incurring of liabilities in excess of 1 and 1/2 times shareholders funds or 3/5 of total tangible assets. Where the Committee had granted official quotation to such an issue, the issuing company had to disclose, in a footnote to each balance sheet issued during the currency of the issue, the amount of liabilities (as defined by the trust deed) due to mature within (i) one year, and (ii) two years, and the amount of indebtedness to the company due for repayment (i) between 2 to 5 years, and (ii) after 5 years. A statement of similar form had also to be delivered to the Stock Exchange as part of the company's half yearly report [AASE Circular to listed companies dated 20/6/61]

In August 1964, the AASE issued a revised edition of its Listing Manual. The revised manual was largely an embodiment of the listing requirements as at June 1961 and incorporated the changes induced by the Uniform Companies Act and the Public Borrowings Act [Urquhart 1964]. A new section D covering trust deeds was introduced and set out several requirements not codified in previous manuals. Borrowing limitations had to be stated in the trust deeds. For this purpose, transactions with a holding company or a subsidiary company were not to be counted as assets unless supported by a guarantee. Quarterly reports to the trustees along lines similar to the requirements of the Companies Act were introduced. Where a borrowing company was bound by law to prepare a half yearly report, a copy of that report had to be submitted to the trustee and to the Stock Exchange. Section D contained a note stating that the Exchange will not enforce any of the listing requirements relating to the trust deed if the trustee or the company to be appointed trustee for the issue so requests.

In July 1979, the third reprint of the Listing Manual was issued by the AASE as a result of a complete revision of the listing requirements. This revised Listing Manual included, in Section 2D, provisions relating to trust deeds governing issues of loan securities executed prior to 1 July 1979. A new Section 2E was introduced governing trust deeds executed on or after 1 July 1979. Requirements relating to trust deeds governing debenture, mortgage debenture and unsecured note issues were separately enumerated. The 1979 Official Listing Requirements included a general note under Section E stating that the AASE may agree to waive or alter any of the requirements in relation to the trust deed of debenture, mortgage debenture or unsecured note issues, provided that any such waiver or alteration has been agreed to in writing by the trustee for the loan security holders.

On 1 July 1981, the Official Listing Requirements were amended with sections 2E(12A - 12F) introduced to provide for the issue of convertible notes on the basis of a trust deed which specifies stated borrowing limitations based on the consolidated assets and liabilities of the borrowing company and its subsidiaries, including assets situated overseas [Supplement No 5, AASE Amendments to the Official Listing Requirements, 1 July 1981]. On 1 August 1982, the Requirements were amended to extend these same rules to unsecured note issues [Supplement No 6, AASE Amendments to the Official Listing Requirements, 1 August 1982]. On 1 August 1986, the requirement of quarterly reports was deleted from the Listing Requirements [Supplement No 10, AASE Amendments to the Official Listing Requirements, 1 August 1986].

The AASE requirements relating to convertible note trust deeds can therefore be analysed over 3 distinct periods. As described above, the AASE requirements relating to trust deeds for debenture, mortgage debenture and unsecured note were first codified in 1964. The same set of rules were prescribed for these loan securities until 1 July 1979, when with the issue of the 1979 Revised Listing Manual, separate rules were prescribed for each of these type of loan securities. On 1 July 1981, new rules were prescribed for convertible note trust deeds. Prior to that date, a convertible note trust deed had to comply with rules governing an unsecured note trust deed. The detailed requirements for each of the three periods follow.

**A) Trust Deeds governing Convertible Note Issues prior to 1 July 1979**

Trust deeds governing convertible note issues prior to 1 July 1979 had to contain provisions to the following effect:

1(A) A limitation on amount of borrowings that the borrowing company may at any time create or have in existence pursuant to the trust deed.

(B) For the purpose of ascertaining the total amount which the borrowing company may borrow,

(a) any advances other than secured advances made by the borrowing company or any guarantor companies to related companies, and
(b) any investment by the borrowing company or any guarantor companies in shares in related companies

shall not be taken into account as an asset unless,

(i) the company to or in which such advances or investments are made is a guarantor company and covenants with the trustees to limit itself to the same limitation of liabilities as applies by virtue of the trust deed to the borrowing company; or

(ii) the investment satisfies the following requirements:-

(a) it is quoted on the Stock Exchange,
(b) the trustee has been given the first charge over the relevant shares, and
(c) a borrowing limitation of secured liabilities not exceeding 40% of tangible assets of borrowing company and guarantor companies has been written into the trust deed.

The investment aforesaid may then be taken into account as assets, at the lower of the market value and book value or at the valuation by a competent valuer approved by the trustees, subject to a maximum aggregate amount not exceeding 15% of tangible assets of the company and guarantor companies before taking this investment into account.

2) A covenant binding the borrowing company, that at the request of the trustees, to cause any wholly owned subsidiary to become a guarantor company. The trust deed may qualify the trustee's power to request for adding of guarantors to situations when the borrowing limitation has been or is believed by the trustees to have been infringed or its maintenance threatened.

3) That a quarterly report by directors is to be made to the trustees within one month of the end of each reporting quarter stating, inter alia,

(a) whether or not the borrowing limitations have been exceeded;
(b) whether or not there has been any substantial changes in the nature of the business of the borrowing company or any of its subsidiaries or any of it guarantor companies since the debentures were first issued which has not been previously reported and if so, particulars of that change; and
(c) whether or not the borrowing company has lent money to or assumed any liability of a related company, and if so, particulars of each incident.

[s2E AASE Official Listing Requirements 1979]

In summary, it is important to note that although a borrowing limitation covenant was required in the trust deed, the AASE did not specify the quantum to be applied or the basis of the computation. Also, no definitions of the composition of the Group, assets and liabilities were specified. This left the determination on such matters open to negotiation.

**B) Trust Deeds governing Convertible Note Issues executed between 1 July 1979 and 30 June 1981.**

The trust deeds had to contain provisions to the following effect:

1(A) A limitation on all liabilities and secured liabilities that the borrowing company and any guarantor company may incur or allow to subsist.

(B) The consolidated assets and liabilities of the borrowing company and the guarantor companies are to be used in computing the liability limitation subject to the following adjustments:

(a) all intangible assets are to be excluded,
(b) any advances to any non guarantor related companies are to be excluded unless:
  (i) it is secured by first mortgage over freehold land, or
  (ii) such advance is otherwise secured by a first floating charge or by other security of a nature approved by the trustee, provided that the amount that shall be taken into account shall not exceed 10% of the aggregate book value of the aggregate assets of the company and any guarantor companies without, making the adjustments referred to in this paragraph and in paragraph (d),
(c) any investment in unquoted non-guarantor related companies is to be excluded, and
(d) where the investment is in a quoted non-guarantor related company, the amount that can be taken into account shall not exceed the lower of the market value and book value of the share nor exceed 15% of the aggregate assets of the borrowing company and any guarantor company without

making the adjustments referred to in paragraph (b) and (d).

2) A covenant that the borrowing company will adequately insure or cause to be insured the assets of the borrowing company and each guarantor company against all risks properly insurable against. The borrowing company will cause the directors to certify to the trustees on an annual basis that this covenant has been fully complied with.

3) A covenant that the borrowing company will, on request in writing by the trustee, cause any wholly-owned subsidiary of the borrowing company to become a guarantor company. The trust deed may qualify the trustee's power to request for adding of guarantors to situations when the borrowing limitation has been or is believed by the trustee to have been infringed or its maintenance threatened.

4) That a quarterly report by directors is to be made to the trustee within a month of the end of each reporting quarter. The content of the report is similar to that required by the Companies Act [see section 2.2.1B above].

5) Covenants that give effect to the requirements of s154(1) and s154(2) of the Companies Act 1981. [see section 2.2.1B above].

[s2E AASE Official Listings Requirements 1981]

In summary, the changes introduced by the 1979 Listing Manual were to define the Group as the borrowing company and guarantor companies. No definition of assets and liabilities for the purpose of the restrictive covenants was provided, although intangible assets have been specifically excluded and a restriction specified in respect of the amount that investments in and advances to non guarantor companies could be added to assets. No quantification of the borrowing constraint was specified. The other major change in this period was the introduction of the obligation on the borrowing company to insure and to cause to insure the assets of the borrowing company and of the guarantor companies.

C) **Trust Deeds governing Convertible Note Issues after 1 July 1981**

Trust deeds governing convertible note issues after 1 July 1981 had to contain provisions to the following effect:

1(A) A limitation on all liabilities and on secured liabilities that the borrowing company and its subsidiaries may incur or allow to subsist;

(B) A covenant that in calculating the liabilities mentioned above, the assets, excluding intangible assets, and liabilities of the borrowing company and all its subsidiaries will be consolidated;

2) A covenant that requires any guarantor subsidiary company to observe the liability limitation constraint;

3) A covenant that the borrowing company will, at the request of the trustees, cause any wholly owned subsidiary company incorporated in Australia to become a guarantor;

4) A covenant that requires the assets of the borrowing company and each subsidiary company to be properly insured against all risks. The borrowing company will cause the directors to certify to the trustees on an annual basis that this covenant has been fully complied with;

5) That a quarterly report is to be made to the trustees. The content of this report is similar to that required of the trust deed dated prior to 1 July 1979. [On 1 August 1986, this requirement of the Stock Exchange was deleted from the Official Listing Requirements and quarterly reporting is now only required from a company that is a borrowing corporation under the Companies Act.]

6) Covenants that give effect to the requirements

of s154(1) and s154(2) of the Companies Act 1981. [see section 2.2.1B above].

[s2E AASE Official Listings Requirements 1982]

In summary, it is important to note that whilst the quantification of the borrowing constraint remained unspecified, the definition of the Group was changed to that of the company and all its subsidiaries. For the purpose of the restrictive covenants, assets and liabilities were not defined, but intangible assets have been specifically excluded. A consequence of the new definition of the Group is that the treatment of investments in non-guarantor related companies, required in trust deeds prior to 1 July 1981, is no longer applicable.

D) Financial Reporting under the AASE Listing Requirements

The AASE Official Listing Requirements do not require the submission of financial accounts to the trustees. The AASE reporting requirements do not discriminate between the type of securities listed and require the issuing company to submit, to its shareholders and the Stock Exchange, its audited annual accounts prepared in accordance with the requirements of the Companies Act and section 3E of the Official Listing Requirements within 4 months of the end of the financial year [s3C(1) Official Listing Requirements 1986]. A half yearly report on consolidated income only, is to be submitted to the Stock Exchange within 3 months after the end of the first half yearly period in each financial year [s2B(1) AASE Official Listing Requirements 1986]. There is no requirement to prepare a full set of consolidated financial statements for the half year. A preliminary final statement containing information about the profit and loss account is also to be submitted to the Stock Exchange within 3 months of the end of the final year [s38(2) AASE Official Listing Requirements 1986]. The AASE, while specifically requiring certain disclosures over and above that required under the Companies Act, do not specify any accounting measurement rules to be adopted by listed companies. The AASE recommended that, after 1974, published accounts should, in normal circumstances, be prepared in accordance with the statements of accounting standards issued from time to time by the Institute of Chartered Accountants in Australia and the Australian Society of Accountants [s8(10) AASE Official Listing Requirements 1974]. This recommendation did not appear in the Revised Listing Manual issued in 1979. In August 1986, the Listing Requirements were amended to require that information contained in the half yearly report and preliminary final statement be based on financial information that is made out in accordance with applicable approved accounting standards, i.e., those standards approved by the Accounting Standards Review Board [Supplement No 10, AASE Amendments to Official Listing Requirements, August 1986].

## 2.3 Conclusions

There are four points to be emphasised by way of conclusion on the impact of statutory and AASE requirements on covenants and accounting principles in convertible note trust deeds.

First, the statutory requirements under the Companies Act are only applicable to borrowing corporations. If the issuing company is not a borrowing corporation as defined by the Act, only the rules of the AASE need to be complied with.(9)

Second, unless the issuing company is a borrowing corporation as defined by the Companies Act, there is no statutory requirement for the company to submit annual or half yearly financial statements to the trustees. However, prior to 1 August 1986, the AASE required of all companies issuing convertible notes to furnish quarterly reports similar to that required of borrowing corporations under the Companies Act.

Third, and most importantly for this study, a trust deed governing a listed convertible note issue has been required, under the AASE Listing Reguirements since 1964, to contain a borrowing limitation clause. The form that this limitation is to take is left open to negotiation between the contracting parties. For the purpose of the borrowing limitation clause, only the definition of the

Group and the exclusion of intangible assets are specified by the AASE regulations. No rules have been prescribed as to how the assets and liabilities are to be measured.

Finally, in both the 1964 and 1979 Listing Manuals, the AASE advised that they may agree to waive or alter any of the stipulated requirements in respect of the trust deed if the trustee so requests. To the extent that such requests could be made, the terms of the trust deeds are freely negotiable and subject only to the requirements of the Companies Act if the issue is one made by a borrowing corporation.

An analysis of the restrictive covenants and negotiated accounting principles contained in the trust deeds of convertible note issues is provided next in Section 3.

# 3 ANALYSIS OF NEGOTIATED COVENANTS AND ACCOUNTING PRINCIPLES IN CONVERTIBLE NOTE TRUST DEEDS

This section reports the results of an examination of the negotiated covenants and negotiated accounting principles in convertible note trust deeds. The section concludes with an analysis of the degree of correspondence between the negotiated accounting principles and accounting standards in Australia.

## 3.1 Data

### 3.1.1 Period of Study

The study surveyed the trust deeds governing convertible notes issued between January 1976 and December 1985 by companies listed on the Industrial Board of the Stock Exchange. The year 1976 was selected because 1 January 1976 marked the commencement of the current regime of rules governing tax deductibility of interest of convertible notes. The sample period spans a period of intense accounting standard setting activity in Australia in which there was increasing public awareness of the importance and need for standards. This was generated, in part, by the Campbell Inquiry into the Australian Financial Systems and debates surrounding the formation of the Accounting Standards Review Board. Consistent with one of the objectives of the study, the sample period also substantially overlaps the period surveyed by Whittred &

Zimmer (1986). Whittred & Zimmer (1986) examined trust deeds governing debt issues between 1972 and 1983. Their sample of convertible note issues consisted of 15 issues listed on the Stock Exchange between 1975 and 1982. Of the 14 issues listed between 1976 and 1982 in their sample, 12 have been included in the current study. This overlapping of sample periods enables comparison to be made between the larger sample of convertible note issues and their findings on debenture and unsecured note issues and to provide evidence of developments in the covenants and accounting principles written into convertible note trust deeds since 1982.

### 3.1.2 Sample of Trust Deeds

Issues of convertible notes were identified through the Sydney Stock Exchange Investment Review Service (current at 30 August 1986), commonly referred to as the "Red Book". Details of convertible note issues, irrespective of whether they were listed or private issues, form part of the key data provided for each company in the Review Service Report. The AASE's pro-forma balance sheet classifies convertible notes as an item by itself under deferred liabilities and included in each Review Report is a 7 year series balance sheet in this format. Companies delisted between 1 January 1976 and 30 August 1986, whose Review Reports were not in the current issue of the Red Book, were traced through the Monthly Report of Amendments to the Service and copies of the last Review Report prior to delisting were inspected. As the pro-forma balance sheet in the Review Report covered a 7 year period, in order to ensure that all convertible note issues for the sample period were included, the Review Reports for the companies for 1979 and 1980 were also examined.

In view of the loose-leaf nature of the Investment Review Service and the consequential risk of the incompleteness of reports reviewed, the listing of convertible notes identified through the Investment Service was verified against the December Report of the Monthly Share Performance published in the AASE Official Journal and the Personal Investment magazine for each of the years 1975 to 1985 to ensure that all listed convertible notes had been identified.

Table 1 contains details of the known convertible note issues and their trust deeds. The overlap with the Whittred & Zimmer sample is also described in the table. A total of 82 issues of convertible notes were identified. These issues are listed in Appendix 1. A review of the company papers filed with the Sydney Stock Exchange Library revealed that 13 issues were not subject to any trust deeds.[10] All but 2 of the remaining 69 issues which were subject to trust deeds were listed on the Stock Exchange. Three (3) companies negotiated new trust deeds for their second issue. One of these companies and 5 others made use of the same trust deeds for 2 issues each.

## TABLE 1

A written request was made of those companies whose copy of the trust deed for a convertible note issue could not be located at the Sydney Stock Exchange Library. Of the 35 letters of request for copies of trust deeds sent, 15 companies responded (a response rate of 43%) making available trust deeds covering 17 issues. One company declined to release the information while 2 others (including a company that had provided a copy of the trust deed for its current convertible note issue) advised that they were unable to provide copies of the trust deeds in respect of redeemed issues as copies could not be readily located. Five (5) letters were returned undelivered.

Follow-up action revealed that one of these companies had ceased operations shortly after the issue of the convertible notes and that the issue was subsequently cancelled. The other 4 companies have been acquired by other companies. A review was made of the letters of offer in the cases of the issues for which no response was received and in the cases of the returned letters. To comply with the pre-requisite for official listing, the prospectus or letter of offer in respect of convertible note issues has to contain, among other information, a statement of the basis of calculation of the borrowing limitation and in summary form, the main terms of the covenants required to be given by the company pursuant to this borrowing limitation covenant [s2A(7) AASE Official Listing Requirements, August 1986]. The prospectuses and letters of offer of 13 companies were found to contain the extracts of the trust deed clauses governing the borrowing constraint and the definition of the terms used in the clause.

For the companies for which no extracts of the trust deeds were available, the companies were contacted by telephone. This yielded 1 trust deed covering 2 issues. Eight (8) companies advised that their company had been the subject of takeover and that the convertible notes were also acquired and trust deed discharged and that the trust deed was no longer in the public domain or could not be readily located.

The final sample for analysis was 58 issues [45 with trust deeds & 13 with extracts only] representing 84% [65% trust deed & 19% extracts] of the population of convertible note issues between 1976 and 1985. It included 2 of the 3 issues made to the public by borrowing corporations during the sample period and 1 of the 2 issues made pursuant to takeovers. The 2 unlisted convertible note issues which were not subject to regulatory requirements on trust deeds were also included in the final sample.

### 3.2 Negotiated Covenants

The covenants written into the convertible note trust deeds examined included restrictions on disposal of major assets, obligations to insure assets and restrictions on borrowings. There were no covenants that specified a minimum interest cover contained in any of the deeds.

Covenants imposing <u>restrictions on the disposal of major assets</u> or undertakings of the business were contained in 80% of the trust deeds examined. Sixteen percent (16%) of the trust deeds restricted the disposal of shares in subsidiary companies while restriction on the reduction of paid up capital was written into 78% of the deeds. Thirty-six percent (36%) of the deeds placed restrictions on the redemption of preference shares. The approval of the trustee had to be obtained before any of these actions can be undertaken.

The <u>obligation to adequately insure or cause to insure assets</u> of the borrowing company and its subsidiaries is one imposed upon issuing companies subsequent to 1 July 1979 by the AASE requirements [see 2.2.2B above]. This covenant was found in all trust deeds examined, indicating the covenant to insure was negotiated by parties to the trust deeds prior to July 1979. In 67% of the deeds, the measure of adequacy of coverage was defined as `what a prudent company engaged in similar business will insure'. Under certain circumstances, insurance need not be purchased. A proviso written into the trust deeds to exempt the need to insure "that which is not in the normal practice of the company to insure", was contained in 20% of all deeds while in 36% of all deeds, insurance need not be taken "if and to the extent that in the opinion of the directors, formed having regard to the interest of the noteholders, that insurance is not necessary or would not (having regard to the premium payable and other relevant factors) be in the interests of the company to insure." The scope of insurance therefore rests largely with the directors and the trustees are empowered to accept a statement from the directors that the covenant to adequately insure has been fully complied with [see 2.2.2B].

Table 2 summarises the borrowing limitations in the 58 convertible note issues examined in this study. Two (2) of the issues by one company were not subject to any borrowing constraints [(11)], while 1 issue only imposed the maximum amount of convertible notes that the company could borrow. A further 3 issues contained this latter limitation in addition to the liability limitation. The limitation on liabilities extends over both the amounts of total external liabilities (TEL) and of secured liabilities (SL) that the company may incur or allow to subsist. As discussed in section 2.2.2 above, the AASE amended its listing requirements to permit listing of convertible notes issued after 1 July 1981 which have the limitation of liabilities computed on the basis of assets and liabilities of the borrowing company and all its subsidiaries. The first issue incorporating the new basis of computation was made in June 1980. By 1981 most of the new issues had been written in terms of the new rules.

TABLE 2

The limitation on liabilities was defined relative to total tangible assets in 75% of the issues. For the remaining 25% that wrote the limitation relative to shareholders funds [denoted by * in Table 2], shareholders funds was defined as either shareholders funds less intangible assets or the excess of total tangible assets over total external liabilities. Hence in all cases, the liabilities limitation was measured in terms of tangible assets. These constraints are of a continuing nature in that any violation at any point in time during the currency of the notes constitutes an act of default.

The permitted level of liabilities varied across issues by companies in different industries. This is depicted in Table 3 where the Developer & Contractors industry classification has the least restrictive limits.

TABLE 3

Table 4 shows that the level of liabilities permitted for convertible note issues specifying the Group as being that of the company and its subsidiaries, are higher than those issues specifying the Group as being that of the company and the guarantors. Tests of differences revealed the limitation of total external liabilities to be significantly different at the 9% level. These permitted percentages were higher than the limits subsisting in debenture deeds reported by Whittred & Zimmer (1986).

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TABLE 4

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### 3.3 Negotiated Reporting Obligations

This section is based upon the survey of the 45 trust deeds examined. Insufficient information was available from the extracts of trust deeds to include them for the purpose of this section of the analysis. Of the 45 deeds, only 1 trust deed relates to an issue of convertible notes to the public by a borrowing corporation.

As described in section 2.2, borrowing corporations issuing convertible notes are subject to 3 different types of reporting obligations. The quarterly report by directors is an AASE requirement for all convertible note issues prior to 1 August 1986. The obligation to report on the financial position of the company and to report on the creation of charges to the trustees are, however, statutory requirements applicable only to borrowing corporations as defined by the Act. The evidence below reveals that these reports were negotiated for in certain deeds irrespective of the borrower's borrowing corporation status. There was also evidence that reports by the auditors and other reports by directors were negotiated for in the deeds. There were no regulatory requirements for such reports. This evidence is summarised in Table 5.

TABLE 5

A) Reporting of Financial Position to Trustees

All 45 of the trust deeds required the audited annual accounts to be submitted by the company to the trustees within 4 months of the end of the financial year.

Sixty percent (60%) of the deeds required half yearly financial accounts to be prepared and submitted to the trustees, while a further 7% of the deeds stipulated that they need to be submitted to the trustee if there is a statutory requirement to prepare them. Four percent (4%) of the deeds required half yearly accounts only if there was a statutory requirement or when a loss was incurred in respect of the previous year.

In 53% of the deeds the trustees could require a set of financial accounts to be prepared at their request. In these cases, the accounts would have to be prepared on the same basis as the annual accounts.

In all cases where the definition of Group was company and guarantor companies, the annual report and half yearly accounts also had to include consolidated accounts of the borrowing company and guarantor companies.

B) Reporting of Creation of Charges to Trustees

This was written into 27% of the trust deeds surveyed. In all these instances, the issuing companies were not borrowing corporations as defined by the Companies Act.

C) Reporting of Compliance with Trust Deed to Trustees

i) Quarterly Report By Directors

All but 2 deeds surveyed included covenants requiring the submission of quarterly reports. These 2 deeds governed convertible note issues which did not contain borrowing constraints, and so no report was necessary.

ii) Report by Auditors

In 87% of the deeds, an annual report by auditors was to be prepared and submitted to the trustees at the same time as the annual accounts. To be included in this report was a statement of the amount of total tangible assets, total external liabilities, secured liabilities and/or shareholders funds computed on the basis of the definition as stated in the trust deed and including details of any adjustments made by the auditors. The report also had to include the auditor's report as to whether any trust deed conditions, including borrowing con straints, had been violated by the company.

Fifty-one percent (51%) of the deeds required a half yearly report by the auditors to be submitted. A further 9% required this report only if the half yearly accounts have been duly audited and 7% required it if the half yearly accounts were required. Thirty-six percent (36%) of the deeds also provided for reports to be prepared at the request of the trustees.

iii) **Report by Directors**

Eleven percent (11%) of the deeds required the directors to submit to the trustees annual and half yearly reports of compliance. Seven percent (7%) required half yearly reports and 4% required half yearly reports only if the half yearly accounts were unaudited. In 60% of deeds requiring a half yearly report, the directors had to advise, inter alia, whether or not there had been any change in the accounting method used and whether or not there were any circumstances that would make adherence to existing accounting methods inappropriate.

Nine percent (9%) of the deeds provided for reporting to be made at the request of the trustee.

Reports prepared for the purpose of monitoring compliance with the borrowing constraints in the trust deed were to be prepared in accordance with the terms of the negotiated deeds. The basis of the computation of the borrowing constraints and the definition of each of the accounting terms to be used were negotiated into the deeds. These definitions are analysed next.

## 3.4 Negotiated Accounting Principles

This section is based upon the survey of the 55 issues which were subject to continuing liability limitation constraints. Recall from section 3.2 that of the 58 issues with trust deeds or extracts of trust deeds available, 2 issues were not subjected to liability limitation constraints while 1 issue only contained a maximum amount of convertible notes that could be borrowed.

### 3.4.1 Definition of Terms

The terms associated with the computation of borrowing constraints are TANGIBLE ASSETS, TOTAL TANGIBLE ASSETS, TOTAL EXTERNAL LIABILITIES, SECURED LIABILITIES and SHAREHOLDERS FUNDS. These terms were defined in the trust deeds and expressed in terms of the amount as disclosed in the latest audited accounts with certain adjustments. The adjustments were of 3 types:

A) Adjustments of an `Updating' Nature

The borrowing constraint is a continuing constraint and is to be complied with at all times during the currency of the debt issue. Reporting of compliance is required on a quarterly basis. Audited accounts, however, are only available in respect of the financial year or sometimes, where the trust deed stipulates, half year [see section 3.3(A)]. The time lag between the date of the audited accounts and the date of reporting could be as long as 13 months. Adjustments of the `updating' nature are introduced to provide a basis for reporting during the intervening reporting periods. Adjustments are made in respect of new share issues, borrowings, interim dividends paid and changes in status of the guarantor/subsidiary companies since the date of the latest audited accounts. Such adjustments take into account the capital financing and structural changes of the Group but not the effects of the operations.

Table 6 shows the types and frequencies of the `updating' adjustments that were written into the negotiated terms. Eighty three percent (83%) or 40/48 of the definitions of total tangible assets specified one or more of the `updating' adjustments referred to above. Only 51% or 28/55 of the definitions of total external liabilities and 43% or 6/14 of the definitions of shareholders funds contained one or more of the `updating' adjustments. Some of the adjustments could be made at the option of the company. The extent of this discretion is also reported in Table 6. The degree of discretion was higher in relation to the definition of total tangible assets (21% or 10/48) than of shareholders funds (7% or 1/14). No cases of discretionary adjustments were observed in respect of total external liabilities.

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TABLE 6

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B) Auditors' Adjustments

The auditors' involvement in relation to the trust deeds takes the form of the preparation and submission of the reports to the trustees referred to in Section 3.3(C). The report by the auditors on the assets and liabilities as defined by the trust deed is to be made based on the latest audited accounts. Some of the adjustments to the accounting terms required the auditors' judgement and opinion. Table 7 provides evidence of the types and frequencies of such adjustments.

## TABLE 7

In 54% of the deeds which defined total tangible assets, the auditors must ascertain what constitutes an intangible asset to be excluded from computations. In 31% of the deeds, contingent liabilities to be included in the total external liabilities were based on the auditors' opinion. In 22% of these cases, the definition of total external liabilities required adjustments in respect of any material changes since the date of the last audited accounts. The auditor's judgement is required as to what constitutes a material change.

Included in the definition of the accounting terms was a discretionary power of the auditors to make `such adjustments, if any, as the auditors consider necessary to make a proper determination of the amount of the accounting term being measured'. This discretionary power was written into 88% (42 out of 48) of the definitions of total tangible assets, 89% (49 out of 55) of total external liabilities and 78% (11 out of 14) of shareholders funds. In half of the definitions of total tangible assets (21 out of 42) and of total external liabilities (24 out of 49) containing this discretionary adjustment and in 73% (8 out of

11) of the definitions of shareholders funds containing this adjustment, specific reference was made to the auditors' opinion to be formed having regard to usual accounting practices for the time being applicable.

These adjustments written into the trust deeds place the responsibility on the auditors to ensure that the assets and liabilities and/or shareholders fund are properly stated. Armitage [1981, p 74] suggested that this discretionary power is aimed not only at rectification of anomalies which could arise due to a rigid or too literal application of the specific adjustment directions, but also to fill in gaps in such directions where it is apparent from their nature that a particular item or situation would have been dealt with in a particular way if it had been considered when the terms of the relevant definition were formulated. It would appear, however, that this auditor's discretionary power was written into the definition specifically directed at post balance-date events that may affect the proper determination of the assets, liabilities and/or shareholders funds for purposes of the quarterly reporting of compliance with borrowing constraints by the directors. In 62% of the definitions of total tangible assets which contained this adjustment, the definition also stated that the auditors, in making these adjustments, need not conduct an audit as at the date of the determination of the amount.

Having regard to the fact that the auditors have to express an opinion on the accounts in the course of the annual audit, if an unqualified report is given, it is unlikely that the auditors could initiate any adjustments in respect of the report of compliance with the trust deed for the first quarter (due within one month after the end of the quarter) without casting doubt on the proper determination of the accounts which form the underlying basis of the computation. The audited annual accounts, which are due within 4 months of the end of the financial year, are likely to be used for the assessment of compliance with the borrowing constraints. The qualifying term `having regard to current generally accepted accounting principles' does not imply that the auditors must adjust for any non compliance with the accounting standards as the over-riding consideration is the proper determination of the amount to be stated in respect of the accounting term. Where the auditors have issued a qualified report, it is conceivable that this discretionary power to adjust would be exercised to report the proper determination of the financial position to the trustees

C) Adjustments reflecting Negotiated Treatment of Certain Items

These adjustments specify the measurement rules to be applied in respect of certain components of the accounting terms and also some of the items to be included or excluded from the accounting terms. Some of the adjustments may require a method of treatment which is entirely consistent with accounting standards. Others restrict the company to a specified rule to the exclusion of other alternatives permitted under the standards or prescribe a rule which is inconsistent with the standards. These adjustments are discussed in Section 3.5 as part of the assessment of the extent of modification of the accounting standards in the negotiated adjustments.

### 3.4.2 Composition of Group Accounts

It was noted in section 2.2.2 that there was a change in the definition of the composition of the Group accounts for the purpose of borrowing constraint computations from that of the borrowing company and guarantor companies to that of the borrowing company and all its subsidiaries in 1980/81. In respect of deeds defining the Group as borrowing company and guarantor companies, the extent to which investments in and advances to the non-guarantor related companies could be added to the amount of total tangible assets have been restricted by the requirements of the AASE. These restrictions imposed by the AASE were as follows:

| | Prior to 1/7/1979 | Since 1/7/1979 |
|---|---|---|
| Amount that could be included to total tangible assets (TTA) in respect of: | % | % |
| Unsecured advances | nil | nil |
| Advances secured by | | |
| - mortgage | 100 | 100 |
| - floating charge | 100 | max of 10% of TTA |
| Unquoted investments | nil | nil |
| Quoted investments | max of 15% of TTA | max of 15% of TTA |

Table 8 reports the evidence of the variation in negotiated treatment of the non-guarantor related company items that can be brought into the borrowing limitation computation in the trust deeds that defined the Group as the company and its guarantors. Differences were observed between the negotiated amounts and the AASE required amounts in 65% of deeds in the case of investments and 88% of deeds in the case of advances.

Table 8

Further analysis (not reported in Table 8), in respect of the 9 trust deeds governing issues announced prior to July 1979, revealed that only 2 deeds adopted the same percentage as set out by the AASE for treatment of investments and 1 deed in the case of advances. Six (6) deeds excluded investments and advances totally, while a higher amount of investments and advances was permitted in 1 and 2 deeds respectively. In respect of the trust deeds governing the 17 issues made after July 1979, 7 deeds followed the same percentage as set by the AASE for investments and 2 deeds in the case of advances. Investments and advances were totally excluded in 5 and 3 of the deeds respectively. Of the remaining deeds, 2 deeds permitted a higher percentage of investments and 7 deeds permitted a higher percentage of the advances to be included.

Apart from this special treatment of non-guarantor related company items in respect of trust deeds specifying the pre-1981 definition of the Group, there are no other differences in the nature of the adjustments being made in deeds adopting either of the two definitions of the Group.

### 3.5 Accounting Standards versus Negotiated Accounting Principles

The underlying audited accounts upon which the borrowing constraints are to be computed are to be prepared in accordance with the requirements of the Companies Act and in accordance with the accounting standards in force in the year of preparation.

The Australian accounting standards are currently being promulgated by the accounting profession [called AAS standards] and by the Accounting Standards Review Board [hereafter ASRB standards]. Compliance with the 8 standards issued by the ASRB is mandatory [s269(8A) Companies Act 1981]. These ASRB standards are also the subject of similar AAS standards issued by the accounting profession.

As the borrowing constraints are continuing constraints, the negotiated adjustments in the accounting principles were compared with all accounting standards in place and exposure drafts issued as at the time of the study (January 1987) or as at the year of the maturity for those issues which have matured. The assessment of the degree of correspondence between the negotiated adjustments and Australian accounting standards followed the approach presented in Figure 1.

FIGURE 1

Each negotiated adjustment in an accounting principle was evaluated to ascertain whether it referred to an accounting area for which an Australian accounting standard or exposure draft exists. Where an Australian accounting standard or exposure draft exists, an assessment was then made as to whether the negotiated adjustment was one that involved the specification of the definition of the accounting base or the specification of the measurement of the defined base:

(a) If it was a specification of the definition of the base for the purpose of the borrowing constraint computation, the assessment was also made as to whether the measurement rule for quantification of that adjustment was consistent with the Australian accounting standards, modified them, or prescribed a treatment that was not within the standards;

(b) If the adjustment was one that specified measurement of the defined base only, the same assessment was made to ascertain whether the method prescribed was consistent with, modified them or was a method not within the standard.

This approach revealed the following evidence.

**A) Adjustments defining the Accounting Base**

Table 9 shows the negotiated adjustments defining the accounting base of total tangible assets, total external liabilities and shareholders funds. It is notable that all forty-eight (48) of the deeds which defined total tangible assets and fourteen (14) of the deeds which defined shareholders funds required intangible assets to be deducted. Hence, the borrowing limitation constraints under all the deeds examined were computed in relation to total tangible assets. When total tangible assets is defined as being assets less intangible assets, the exclusion of intangible assets cannot be described as an adjustment to the determination of the total tangible assets.

**TABLE 9**

B) Degree of Correspondence

Table 10 reports the evidence on the correspondence of the negotiated adjustments in accounting principles with the accounting standards.

TABLE 10

Specific comments follow on each of these adjustments that modified the standards, those which were outside the standards and those which were not subject to any standards.

(a) Accounting standards modified

The following standards have been modified in one or more trust deeds.

Deferred Tax (AAS 3)

Twenty percent (20%) of the issues specifically excluded the provision for deferred tax from total external liabilities. In one of these instances, the treatment required that an amount equal to the future income tax liability appearing in the Balance Sheet be added to total tangible assets with the amount also being included in total external liabilities.

The deferred tax standard is one of the accounting standards which has had a high incidence of non-compliance over the years 1975 - 1979 [see e.g. NSW Corporate Affairs Commission Annual Reports 1976 - 1980]. This evidence on non-acceptance of the deferred tax accounting standard by companies is consistent with the preferred treatment of taxation negotiated in the trust deeds.

Deferred tax benefit was specifically mentioned for exclusion in 46% of the issues. Being an intangible asset, as para 38 of AAS 3 would suggest, this item would be excluded from the total tangible assets of all issues anyway.

Depreciation (AAS 4)

The accounting standard requires depreciation to be charged for all depreciable assets. A typical definition of total tangible assets made mention of adequate depreciation to be deducted. However, in 18% of deeds surveyed, there was an adjustment which permitted `with the consent of the trustees, the writing back of depreciation charged against revenue profits in excess of amount allowed for depreciation by the proper authority under any applicable income tax legislation so long as the write back represents an increase in net book value of the tangible assets'.

This adjustment has the potential of undoing the provision for depreciation of buildings which AAS 4 requires to be made, provided that the trustee agrees with the company that the net value of the buildings has not declined despite the depreciation charged. The adjustment has the potential to result in part of the depreciation charged in respect of the revalued leasehold properties and other assets to be reversed and the de facto revaluation maintained each year without the need for an independent valuer's report. Like AAS 3, AAS 4 has had a record of a high incidence of non-compliance in the financial statements prepared by companies [NSW Corporate Affairs Commission, Annual Reports 1976 - 1980].

## Lease Accounting (AAS 17/ASRB 1008)

The Australian Accounting Research Foundation issued a discussion paper on leasing in 1979 and an exposure draft was issued in 1980. Only 2 issues in 1980 contained provisions relating to adjustments for lease rental. In both these instances, the treatment was to exclude from liabilities the lease rental not yet due. A recent issue (1985) contained the provision to disregard leases of freehold properties which may be capitalised pursuant to accounting standards.

**(b) Negotiated principles outside the accounting standards**

**Asset Revaluations (AAS 10)**

In 82% of all (55) the issues examined, asset revaluations were permitted. Of those issues that only defined total tangible assets (48 deeds), 94% of the definitions included an adjustment for asset revaluations. The deeds specified that in respect of land and buildings, the valuation was to be conducted by an independent valuer approved by the trustees.

Asset revaluations since the date of the latest balance sheet may also be included in total tangible assets for quarterly reporting purposes. Eleven percent (11%) of the deeds permitting revaluation specified the minimum unexpired term of leasehold properties (between 10 to 20 years) for its revaluation to be accepted for inclusion in total tangible assets. Sixteen percent (16%) of the deeds did not require the asset revaluation to be recorded in the books of account for it to be included in the borrowing constraint computation.

Since the AAS 10 is only concerned with how to account for revaluations rather than when they should occur and on what basis they should be carried out [para 14, AAS 10], the negotiated principle is, therefore, outside this AAS standard.

## Equity Accounting (AAS 14)

In the case of 1 deed, where equity accounting had been applied in the financial statements, an adjustment had to be made to write down the value of the investment to its underlying net tangible assets. One other deed required the non-guarantor subsidiary companies to be accounted for at 87.5% of the underlying net tangible assets subject to a maximum of 45% of Group total tangible assets. A third deed which defined the Group as being that of the company and guarantors required the proportional consolidation of its non-guarantor related companies. These negotiated principles are outside the AAS 14 standard.

(c) Negotiated principles not subject to any accounting standards

**Valuation of Quoted Investments**

The negotiated treatment in 20% of the issues was to include in total tangible assets, quoted investments at the lower of market value and book value.

**Contingent Liabilities**

The treatment of contingent liabilities varied across issues. In 31% of the issues, contingent liabilities had to be added to total liabilities if the auditors considered a provision for contingencies to be necessary. Twenty-two percent (22%) of the issues, however, specifically excluded contingent liabilities with half of these issues (i.e. 11% of all deeds) also excluding any provision made for contingencies. There were

2 cases where only a percentage of contingent liabilities had to be added to liabilities. In the first case, the amount to be included for the contingent liabilities under guarantee was the amount equal to the excess over 5% of total tangible assets and in the other case, the amount to be included was 10% of the contingent liabilities arising from guarantees given to the bank and financial institutions in respect of due performance of contracts by the company or its subsidiaries.

**Provisions including bad and doubtful debts, long service leave, losses and amortisations**

In 75% of all deeds examined, adequate provision for bad and doubtful debts, losses and amortisations had to be deducted from the total tangible assets. Sixty percent (60%) of the deeds required a provision for long service leave to be made and deducted from total tangible assets. Three (3) issues permitted the excess of provisions over tax allowance to be written back to total tangible assets and 2 issues permitted the writing back of amortisations charged against revenue.

**Income yet to mature (Unearned income)**

Fifty-five percent (55%) of the deeds required the exclusion of unearned income from the definition of total tangible assets. This is consistent with the Companies Act requirement (in existence at least as early as 1961) that unearned income be deducted from the related assets.

A summary of the correspondence between all the accounting standards in place in Australia with the negotiated adjustments in the principles is provided in Table 11. It can be seen from Table 11 that there are a number of standards which are entirely consistent with the negotiated principles and a number of standards which are not referred to.

**TABLE 11**

**(i) Negotiated principles entirely consistent with Standards**

The negotiated adjustments to accounting principles were entirely consistent with the following accounting standards.

Post balance day events - AAS 8/ASRB 1002
Expenditure carried forward - AAS 9
Goodwill - AAS 18

As discussed in section 3.4, adjustments of an updating nature do not amount to modification of the AAS 8/ASRB 1002. AAS 9 and AAS 18 relate to measurement of intangible assets which by definition are excluded from the base for borrowing limitation computation. Although the negotiated principles required intangible assets to be excluded from the assets base, no specific measurement rule was prescribed. Hence the negotiated adjustments do not modify these standards.

(ii) Standards not referred to in convertible note trust deeds

The following AAS/ASRB standards were not adjusted in the negotiated principles contained in the trust deeds examined.

Profit & Loss Account - AAS 1
Inventory Valuation - AAS 2
Materiality - AAS 5
Disclosure of Accounting Policies - AAS 6 /ASRB 1001
Accounting for Extractive Industries - AAS 7
Construction Contracts - AAS 11
Fund Statement - AAS 12/ASRB 1007
Research & Development - AAS 13
Disclosure of Revenue - AAS 15/ASRB 1004
Segment Reporting - AAS 16/ASRB 1005
Joint Venture Accounting - AAS 19 /ASRB 1006
Foreign Currency Translation - AAS 20 /ASRB 1003
Acquisition of Assets - AAS 21
Accounting for Leveraged Leases - ED

Since the underlying audited accounts, upon which the borrowing limitation constraints are to be measured, are being prepared in accordance with accounting standards, it can be inferred that the accounting principles prescribed by these standards are acceptable to the parties in negotiating the trust deeds subject, of course, to the discretionary adjustments that can be made by the auditors on their behalf.

### 3.5.1 Correspondence of the Negotiated Principles with the Introduction of Accounting Standards

To assess the impact of the issue of accounting standards, exposure drafts and discussion papers on the negotiation of the trust deeds, a time series comparison of the negotiated principles (which modified the standards and which were outside the standards) and the year of issue of the relevant documents was undertaken and the results are summarised in Table 12.

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TABLE 12

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Table 12 suggests that there is little correlation between the introduction of new accounting standards/ exposure drafts and any induced changes in accounting principles written into the deeds. The attention drawn to the implications of the off-balance sheet financing effect of leases [AARF Discussion Paper (DP 1979), exposure drafts (ED 1980 & ED 1981), DP 1983 & AAS 17 1984] was followed by only 2 trust deeds in 1980 which required adjustments for such off-balance sheet financing. No immediate modification prompted by the Equity accounting controversy [ED 1973, ED 1979, AAS 14 1983 and the amendment to the standard in 1984] was found. The majority of the negotiated adjustments to undo the effects of AAS 3 were written in the early 1980s. Eight (8) out of 11 negotiated adjustments found in the sample were written in the years immediately surrounding 1981, which was the year that a new exposure draft on deferred tax was issued. This exposure draft (ED 1981) however did not modify the basic principles in the accounting standard on the treatment of deferred tax. Of the 15 variations noted in respect of AAS 10, 6 related to the specification of the minimum unexpired term of leasehold properties and 9 provided that the revaluation need not be recorded in the books. Although these negotiated treatments were outside the standard, 7 of the deeds that did not require recording of revaluations in the books were negotiated in the years when the exposure draft and standard were issued.

## 3.6 Conclusions

The negotiated covenants written into the trust deeds surveyed covered restrictions on the disposal of major assets, obligations to insure assets and restrictions on borrowings. The obligation to insure was an AASE listing requirement subsequent to 1979, although the AASE allowed the trustee to waive the covenant. Where this covenant was included, some of the deeds provided for waiving of the requirement.

The main forms of the borrowing constraints covered restrictions on the amount of the total external liabilities and secured liabilities. The results of the survey showed that the negotiated adjustments in the principles, used to define and measure the accounting variables in the borrowing constraints, only modified three of the accounting standards - the exclusion of lease liabilities and deferred tax from total external liabilities and the undoing of depreciation of buildings. Negotiated accounting principles not subject to accounting standards were few in number. In general, the accounting standards appear to be adequate to the contracting parties to these trust deeds.

Further, there was no evidence of any major accounting standard induced adjustments in the convertible note trust deeds.

Finally, there was evidence of a number of deeds containing (negotiated) agreements to report information to the trustees.

In the next section, a comparison of the results of this examination are made with those of the earlier study by Whittred & Zimmer.

# 4 COMPARISON WITH THE WHITTRED AND ZIMMER STUDY

In this section, the findings of the survey of convertible note trust deeds, as reported in Section 3, are compared with Whittred & Zimmer's analysis of convertible note trust deeds. The section also seeks to compare the nature of the restrictive covenants written into convertible note trust deeds with those in debenture and unsecured note trust deeds.

## 4.1 A Review of Whittred & Zimmer Papers

Whittred & Zimmer (1986) [hereafter W & Z 1986] was the first Australian study to examine in detail the negotiated accounting principles in trust deeds governing public debt issues (including convertible notes). The period of their study was 1972 to 1983. The findings of their study were first presented at the 1984 Annual Conference of the Accounting Association of Australia and New Zealand in a paper entitled "The Role of Accounting Information in Australian Debt Contracts " - Whittred & Zimmer (1984) - [hereafter W & Z 1984] and later at the 5th Coopers & Lybrand Accounting Education and Research Conference in 1985 under the title, "Accounting Rules negotiated in Trust Deeds: A comparison with Accounting Standards" - Whittred & Zimmer (1985) [hereafter W & Z 1985].

#### 4.1.1 Whittred & Zimmer (1984)

In the 1984 paper, Whittred & Zimmer reviewed the borrowing constraints written into debenture and unsecured note trust deeds issued over the period 1972 to 1983. Their sample consisted of 18 debentures and 8 unsecured note deeds, representing 62% and 64% of their respective population. Adopting the approach used by Leftwich (1973), they assessed the degree of compliance of the negotiated accounting rules to be applied in the computation of the liability limitation constraints with GAAP (defined as the 14 accounting standards on issue at the time of their study and 12 accounting measures in respect of which either an exposure draft was issued or the topic was on the agenda of the accounting standards setting bodies). They concluded that, in the majority of cases [14 out of 26] accounting principles negotiated were inconsistent with GAAP [W & Z 1984, p 25]. These included 8 out of the 14 standards in issue [W & Z 1984, p 19].

Whittred & Zimmer then evaluated the extent of discretion management may have in loosening the constraint contained in the trust deeds and reported that no contract in their sample specified the accounting principles <u>per se</u> to be adopted for any item [W & Z 1984, p 27]. Whittred & Zimmer concluded that management had considerable discretion in the choice of accounting techniques [W & Z 1984, p 30] and that the only substantive constraint on this choice was the power of the auditors to make discretionary adjustments [W & Z 1984, p 30].

Whittred & Zimmer finally concluded that the contracts appear to respond to mandated changes in GAAP by undoing the effects of the change completely, or by selectively excluding (including) those parts of it, that work to the detriment (benefit) of the debtholders [W & Z 1984, p 30].

#### 4.1.2 Whittred & Zimmer (1985)

The 1985 paper was essentially similar to the 1984 paper except that the emphasis was only on the assessment of the degree of compliance with accounting standards. The paper reported only on the accounting standards governing measurement rules. Whittred & Zimmer reported that negotiated principles were at variance with 6 out of the 11 mandated accounting measurement standards but listed 7 instances of the standards being modified [W & Z 1985, p 11]. Standards issued subsequent to their 1984 paper were also evaluated and the negotiated principles were reported to be at variance with 2 of the 3 new standards. The list of standards reported to be at variance with the negotiated principles differs from that reported in the 1984 paper as is indicated in Table 13 (discussed later).

#### 4.1.3 Whittred & Zimmer (1986)

In their 1986 paper, Whittred & Zimmer extended the scope of their survey of debt contracts to include 15 CN deeds, representing 30% of the population, issued between 1975 and 1982 (12). They analysed the borrowing constraints imposed on the 3 types of debt issues - debentures, convertible notes and unsecured notes - and reported that the more secured the debt, the tighter the restrictions that exist on both the amount of total liabilities and on secured liabilities of the issuing company [W & Z 1986, p 24].

The paper reported on the variation of accounting practices noted in the negotiated rules. Except in the case of intangible assets [W & Z 1986, p 27], no assessment is made as to whether or not the variation in negotiated rules were at variance with the standards. Whilst the 1984 paper reported no instances of measurement rules being prescribed by the deeds, the 1986 paper noted that measurement rules have been prescribed in 2 instances - for revaluation of assets and investments in marketable securities [W & Z 1986, p 25].

Whittred & Zimmer observed some convertible note trust deeds adopting a `broader' definition of the Group - that of the company and its subsidiaries - instead of the Group being defined as the company and the guarantors and also some differences in the negotiated definition of total tangible assets and concluded that the definition of total tangible assets in convertible note trust deeds was generally less stringent than those under the debenture and unsecured note trust deeds [W & Z 1986, p 27].

The nature of the purportedly less stringent requirements is discussed in sections 4.2.3 and 4.2.4 below.

In assessing the deeds as determinants of accounting policy choice, Whittred & Zimmer drew the same conclusion as in their 1984 paper, that is,

> "since the only restrictions on the accounting treatment <u>per se</u> to be afforded those items permitted in a consolidation for the purposes of the trust deed is that it be in accordance with "usual accounting practice", management has a considerable amount of discretion in its choice of accounting technique. The only substantive contractual constraints on this discretion are the systematic deductions from total tangible assets and the power of the auditor to make discretionary adjustments" [W & Z 1986, p 30].

### 4.2 Comparison of Results

The comparison is made principally with Whittred & Zimmer (1986) since it is the 1986 study that covered convertible notes issues and reported their final analysis of the data they had collected and researched over two years. References are made to their earlier works to examine their detailed assessment of the degree of correspondence of the negotiated accounting rules with the accounting standards.

#### 4.2.1 Sample of Convertible Note Issues

Whittred & Zimmer (1986) examined the trust deeds governing 15 convertible note issues listed between 1975 and 1982. These trust deeds were dated between March 1974 and August 1982. As at August 1982, the accounting standards they used were contained in the 10 AAS statements in place and 6 exposure drafts issued.

The present study examined 58 convertible note issues (45 trust deeds and 13 extracts of trust deeds) listed between 1976 and 1985. Of these, 46 were issued between 1976 and 1982 and included 12 of the 14 trust deeds in Whittred & Zimmer's sample during the same period. The trust deeds examined were dated between November 1972 and September 1985. Ten of the 58 trust deeds were dated after August 1982. As such the present study can examine the impact of the 11 additional standards, issued since August 1982, on the negotiated principles written into trust deeds executed between August 1982 and 1985. The present study, therefore, extends Whittred & Zimmer's in two ways - examining an extended (in terms of size and time period) sample and providing an update of the degree of correspondence of negotiated accounting principles in the convertible debt market with accounting standards.

Another aim of the present study was to compare the nature of the restrictive covenants written into convertible note trust deeds with those reported in the Whittred & Zimmer studies. Attention is drawn to the difference in the time period of the samples of debenture, unsecured note and convertible note trust deeds examined by this study and by Whittred & Zimmer (1986). Seventeen (17) of the 18 debenture trust deeds and 5 of the 8 unsecured note trust deeds examined by Whittred & Zimmer were dated prior to 1976. In comparison, 6 out of 58 trust deeds examined in this study were dated prior to 1976. This mitigates the extent to which comparisons can be made across the different debt issues. Comparisons can, however, be made between the convertible note issues in the W & Z (1986) study and the current study.

#### 4.2.2 Negotiated Covenants

Whittred & Zimmer (1986, p 23) reported that the constraints on both total and secured liabilities were written into debenture, unsecured note and convertible note trust deeds. They noted that the permitted level of borrowings in respect of both the amount of total liabilities and of secured liabilities for convertible note issues were higher than that permitted for debenture issues but lower than that for unsecured note issues.

Whittred & Zimmer (1986, p 25) reported that the interest coverage constraint and the restriction of prior charges constraint did not typically appear in unsecured note and convertible note trust deeds.

This study observed that the level of borrowing permitted for convertible note issues was higher after the change of the definition of the Group to that of the company and its subsidiaries in 1981 [see Table 4 in section 3.2]. The level permitted was higher than that of the debenture trust deeds and lower than that of the unsecured note trust deeds reported by Whittred & Zimmer

(1986, p 24).

This study found no evidence of interest coverage constraints or restrictions on prior charges constraints in the convertible note trust deeds surveyed.

### 4.2.3 Group Definition

Whittred & Zimmer observed a systematic difference between convertible note deeds and the trust deeds governing debenture and unsecured note issues and concluded that the convertible note deeds are generally less stringent than the debenture or unsecured note deeds in that convertible note deeds tended to adopt a broader conception of the Group [W & Z 1986, p 24]. An examination of the time period covered by their 15 convertible note deeds revealed that there was a change of definition of Group in their sample co-inciding with the AASE's change of rule in July 1981. This is shown in Table 13 where post 1981, the group was more broadly defined to be the company and its subsidiaries [see earlier discussion in section 2.2.2].

TABLE 13

### 4.2.4 Negotiated Accounting Principles

Whittred & Zimmer reported that the measurement of the accounting variables specified in the restrictive covenants was by way of systematic adjustments to the reported book value as disclosed in the latest consolidated accounts [W & Z 1986, p 25 & p 28]. They observed that in only a few debenture trust deeds were interest coverage constraints imposed and the definition of income measurement given. They observed that the negotiated definition of accounting variables for debentures, unsecured notes and convertible notes were similar but in the debenture trust deeds, assets not charged in favour of the trustees were generally excluded from total tangible assets.

This study observed the same approach of making use of the latest available accounts and making systematic adjustments to derive the measure for borrowing constraint reporting. No cases of convertible note trust deeds defining income determination were detected. The negotiated adjustment for total tangible assets does not mention uncharged assets as a convertible note issue is unsecured.

Whittred & Zimmer also mentioned that the definition of the total tangible assets in convertible note trust deeds is less restrictive than that of the debenture or unsecured trust deeds in the following respects :

1) In 20% of convertible note trust deeds, there are no restrictions placed on revaluation of assets.
2) The broader conception of Group permits the inclusion of the whole of the investments in non-guarantor subsidiaries.
3) The definition typically does not require the

> exclusion of unearned income and uncharged assets.
>
> [W & Z 1986, p 27]

In contrast to Whittred & Zimmer (1986), the present analysis suggests that there are no significant differences in the definitions of assets and liabilities in the convertible note trust deeds and the debenture or unsecured note trust deeds.

In respect of revaluations, Whittred & Zimmer noted that 89% of debenture deeds and 75% of unsecured note deeds specify the independent valuation rule [W & Z 1984, Table 2, p 10]. The equivalent percentage for convertible note deeds issued prior to 1983 covered by this study is 84% [82% over the period 1976-1985] which is not indicative of any significant difference in the prescribed treatment across the three types of debts. It is noted that the nature of the restriction imposed is that revaluation is to be conducted by an independent valuer. It is possible that, in cases where revaluation is not mentioned, that a directors' valuation could be accepted. The imposition of independent valuation, however, does not, in any way, prevent a revaluation being carried out.

The `broader' concept of the group, ie, the group being that of the company and its subsidiaries instead of the company and its guarantors, eliminates the need for the special rule restricting the percentage of the amount of the investment in and advances to a non-guarantor subsidiary company that could be be added to tangible assets. As is shown in Appendix 2, full consolidation of non-guarantor subsidiaries does not always result in a lower computed liability to asset ratio when compared to the restricted inclusion of only part of the value of the investment to the asset denominator. Hence the re-definition of the Group (post 1981) in respect of convertible note and unsecured note deeds does not necessarily result in a less stringent constraint being imposed.

As for the <u>exclusion of unearned income</u>, para 13(2) of Schedule 7 of the Companies Act requires that unearned income be deducted from the related assets and hence all unearned income would have been excluded even if the deeds do not specify it. The specific reference to exclude unearned income in the definition can be interpreted as reinforcing an obligation to comply with the 7th Schedule provisions on unearned income and not a specification of the assets measurement rule. Based on the information given in Table 2 of W & Z (1984), 72% of debenture deeds and 38% of unsecured note deeds contain this adjustment. By comparison, 55% of convertible note deeds issued prior to 1983 [55% for all issues] that were examined in this study make specific reference to exclusion of unearned income.

Finally, since the convertible notes are unsecured, the issue of <u>excluding uncharged assets</u> from the definition of net tangible asset is not relevant.

### 4.2.5 Accounting Standards versus Negotiated Accounting Principles

Table 14 presents the comparative table of the assessment of compliance with accounting standards by each of the three Whittred and Zimmer papers and by this study. The table is developed from Table 5 of Whittred & Zimmer (1984) and constructed based on an interpretation of the comments contained in their 1985 and 1986 papers. Where an unambiguous assessment could not be made as to whether a standard was regarded by Whittred & Zimmer to have been modified, a `?' is assigned against that standard in the Table. Where no evaluation was made by them in respect of any standard, a `ne' is marked against that standard.

Whittred & Zimmer assigned negotiated treatment into 2 mutually exclusive groups - either `entirely consistent with GAAP' or `modified GAAP'. Where the trust deeds were silent on an accounting standard, the standard was assigned to the former group [W & Z 1984, p 19].

The approach taken in this study was detailed in section 3.5 and depicted in Figure 1. A negotiated treatment that differed from the method mentioned in the standard was analysed to determine whether it was inconsistent with the prescription of the standard or it was a treatment not within the standard. A treatment was regarded as modifying the standard only if the negotiated treatment had been inconsistent with the prescribed method stipulated by the standard.

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TABLE 14

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There are some differences in the assessment of compliance with accounting standards across the three Whittred & Zimmer papers. In the 1984 paper, Whittred & Zimmer, despite commenting on the undoing of the depreciation on buildings [p 20] classified AAS 4 - Depreciation as being entirely consistent with negotiated rules. In respect of AAS 7 - Extractive Industries, they assigned a `?' to this standard in the 1984 paper [Whittred & Zimmer 1984, Table 5, p 18], treated it as being consistent in the 1985 paper [p 11] and in the 1986 paper [p 27] classified it as being modified on the ground that pre-production expenses carried forward is an intangible asset and is therefore to be excluded.

Other comments follow on the remaining differences in assessment of correspondence with standards made by the Whittred & Zimmer studies and by this study.

Intangible Assets

> Whittred & Zimmer (1986, p 27) regarded the exclusion of intangible assets from assets as being tantamount to modification of GAAP. As a result, they classified AAS 7 - Extractive Industries, AAS 9 - Expenditure carried forward, AAS 13 - Research &

Development and AAS 18 - Goodwill as being at variance with negotiated accounting rules. As discussed in section 3.5, this study does not regard the exclusion of intangible assets to be at variance with accounting standards. Tangible assets as defined in the deeds are a subset of total assets and the exclusion of intangible assets cannot be described as an adjustment to the determination of the total tangible assets.

**`Updating'Adjustments (AAS 8/ASRB 1002)**

Whittred & Zimmer [1985, p 12] regarded AAS 8 - Post Balance Sheet Events to have been modified. As is noted in section 3.4, the `updating' adjustments have no impact on the consolidated accounts as at the end of the financial year. When applied at each relevant reporting date, these adjustments would still result in the derived measure being consistent with GAAP.

**Revaluations (AAS 10)**

Whittred & Zimmer [1985, p 13] regarded AAS 10 - Asset Revaluations as having been modified because of the specification of independent valuation. As is pointed out in section 3.5 and 4.2.4 above, AAS 10 does not specify the basis of valuation but merely the accounting of it in the records. As such AAS 10 is not considered to have been modified. Instead, the negotiated accounting principle is considered to be outside the standard.

**Equity Accounting (AAS 14)**

AAS 14 - Equity Accounting was described as being modified in Whittred & Zimmer's study [W & Z 1985, p 14] for the reason that the regulatory requirements require specific exclusion of part of the amount of investment in non-guarantor related companies. The present study identified 3 cases of convertible note trust deeds where the treatment of investments is different from that prescribed under AAS 14.

**Lease Accounting (AAS 17/ASRB 1008)**

Whittred & Zimmer [all studies] reported no evidence of adjustments concerning leases in their sample and assigned AAS 17 - Lease Accounting to the category of being consistent with negotiated rules. The present study identified 3 convertible note trust deeds undoing the effects of this standard.

**Joint Arrangements (AAS 19)**

In the 1984 paper, Whittred & Zimmer regarded the negotiated rules with respect to accounting for joint arrangements to be at variance with GAAP because of the strong incentives not to account for these items in view of the asymmetric treatment of joint venture assets and liabilities [W & Z 1984, p 23]. The present study finds no incidence of joint arrangement accounting being referred to in the convertible note deeds examined.

**Foreign Currency Translation (AAS 20/ASRB 1003)**

Whittred & Zimmer (1984, p 22] assigned a modified classification for this standard on the basis that foreign subsidiaries are to be excluded in the ascertainment of liability limitation constraints [W & Z 1984, p 22]. The present study found no cases of foreign currency translation being referred to in the convertible note trust deeds.

**Business Combinations (AAS 21)**

Whittred & Zimmer [W & Z 1984, p 25] assigned the treatment of business combinations as being modified GAAP on the basis that it is likely that negotiation would be made to permit directors' valuation of the acquired assets and liabilities under `purchase accounting' of acquired companies [W & Z 1984, p 25]. The present study found no instances of accounting rules for business combinations being specified in the convertible note trust deeds.

**Consolidation**

Whittred & Zimmer (1984, p 24) regarded the specification of the use of the combined assets and liabilities of the company and guarantor as being inconsistent with GAAP. The present study views the definition of the Group as being a definition of the scope of inclusion in the base for the purpose of the borrowing limitation constraint. As such it is not regarded as a specification of a measurement rule and the negotiated basis of consolidation is not regarded as being inconsistent with GAAP. Moreover, there is no accounting standard on consolidations in Australia.

## Reporting Standards

Whittred & Zimmer (1984, p 22) regarded AAS 6 - Disclosure of Accounting Policies as being modified GAAP because few contracts required the disclosure of major accounting policies changes or the quantification of the effect of such changes [W & Z 1984, p 22]. In their subsequent papers, they distinguished between reporting standards and standards specifying measurement rules but no comment was made as to the consistency of the negotiated principles with reporting standards as these standards are simply not relevant to the special reporting requirements under the trust deeds.

## Areas of concurrence of assessment

The only two standards which both Whittred &

Zimmer and this study assessed to be modified GAAP were AAS 3 - Deferred taxation and AAS 4 - Depreciation.

### 4.3 Evaluation of Auditors' Discretionary Adjustments

Whittred & Zimmer (1986, p 30) noted the auditor's discretionary power to make further adjustments and suggested that this power could act as a countervailing force to manager's attempts to relax restrictive covenants through making accounting changes. As was discussed in section 3.4.1 above, the ability of the auditors to exercise this discretionary power is highly constrained by the auditor's opinion in respect of the accounts upon which the computation is being based. It is unlikely that the auditors who have given an unqualified audit opinion could initiate any adjustments in respect of this power without casting doubts on the proper determination of the accounts which form the underlying basis of the computation.

### 4.4 Conclusions

Some differences were detected between the negotiated covenants observed by Whittred & Zimmer and those observed in this study. In contrast to Whittred & Zimmer, the present study suggests there are no significant differences in the definition of assets and liabilities in the convertible note trust deeds and the debenture or unsecured note trust deeds.

While Whittred & Zimmer found over 50% of the accounting standards being modified [1985, p 16], this study argues that only 3 of the accounting standards have been modified - Depreciation, Deferred tax and Lease accounting. The differences between the studies, in this regard, mainly reflects a difference in interpretation of a `modification'. This study views modification as being the specification of a negotiated principle which is not in accordance with the prescription of the standard. Where the treatment is not within the scope of the standard, it has been recognised as such and classified into a category by itself. This finer partitioning in the analysis contrasts with the dichotomous classification rule adopted by Whittred & Zimmer.

## 5 SUMMARY AND CONCLUSIONS

This study extends Whittred & Zimmer's (1986) analysis of the use of restrictive covenants and accounting principles in the debt market by examining a larger sample of convertible note issues over a longer time period. The specific aims of the extension were:

a) to examine the restrictive covenants written into an extended (in terms of size and time period) sample of convertible note trust deeds to provide insights into the nature of the bonding arrangements contained in these trust deeds and then to compare them with those reported by Whittred & Zimmer;

b) to assess the degree of correspondence between negotiated accounting principles in the convertible note trust deeds with the accounting standards in place in Australia; and

c) to examine the impact of the introduction of new accounting standards on the negotiation of accounting principles in the convertible note trust deeds.

The regulatory controls over the convertible note issues were reviewed to ascertain the degree to which the terms of the trust deeds were based on regulations. Borrowing limits must be incorporated into the trust deeds but the form that this limitation is to take is left freely negotiable.

The negotiated covenants, other than borrowing constraints, were found to be mainly in the nature of ensuring that the Group activities and structure could not be significantly altered without the approval of the trustees and ensuring the assets were adequately insured. Some of the covenants were specified in AASE requirements although they could be waived if the trustee so requested.

The main forms of borrowing constraints in convertible note trust deeds covered restrictions on the amount of total external liabilities and secured liabilities that a borrowing company was permitted to have. Consistent with the findings of Whittred & Zimmer, these restrictions were observed to be similar to those in the debenture and unsecured note trust deeds except for the definition of the Group accounts upon which the borrowing limitation constraint was based. The definition of the Group used as the basis of consolidation for the purpose of the liability limitation constraint is an AASE listing requirement. Prior to July 1981, the Group consisted of the borrowing company and its guarantors and post July 1981 this was expanded to be the borrowing company and all its subsidiaries.

The definitions of the accounting terms written into the convertible note trust deeds were analysed and compared with those contained in the debenture and unsecured note trust deeds as reported by Whittred & Zimmer (1986). Consistent with Whittred & Zimmer (1986) the consolidations were found to be based on the latest audited accounts and therefore were not drawn up on the basis of accounting principles in existence at the date of issuing the debt. The adjustments to the latest accounts can be described as those of an updating nature (for events taking place between the date of the audited accounts and the reporting on compliance each quarter), those being at the auditor's discretion to adjust and other `bottom line' adjustments. The auditor's discretion to adjust was observed to be dependent upon the nature of the audit report given on the latest accounts.

A comparison of the adjustments to the definitions of the accounting terms written into the convertible note trust deeds with those contained in the debenture and unsecured note trust deeds [as reported by Whittred & Zimmer (1986)] revealed no major differences in the nature of the adjustments written into trust deeds governing these three types of debt issues. The only exceptions were those due to the unsecured nature of the convertible note issues and to the different definition of the Group used in the trust deeds. These differences did not result in the definitions in the convertible note trust deeds being less restrictive than those in the debenture and unsecured note trust deeds. This conclusion contrasts with that of Whittred & Zimmer (1986). It is difficult to determine to what extent the differential share price reaction to firms' announcements of debt issues may be induced by the covenants written into the trust deeds.

The basis of the computation of the borrowing limitations were examined to assess the degree of correspondence of the negotiated accounting principles with the accounting standards in place in Australia. Whilst Whittred & Zimmer found over half of the accounting standards being modified, this study concludes that the standards have only been modified in 3 instances. The difference in results is due mainly to the difference in interpretation of what constitutes a modification. In this study, a standard was assessed to be modified only if the negotiated measurement principle was inconsistent with the rules prescribed by the standards. Where the negotiated treatment was not within the scope of the standard, it was not regarded as being modified.

The study examined the adjustments in the accounting principles in time series and found no evidence of any major accounting standard induced adjustments in the convertible note trust deeds. The wording and composition of the definitions of the accounting terms to be used for the borrowing limitation covenants were observed to be relatively similar across the trust deeds issued over the sample period. This is evidence that corroborates the proposition that "boiler plates" are used in the drafting of the trust deeds.

The evidence suggests that the convertible note debt market does rely on Australian accounting standards. The study concludes that the accounting standards are generally adequate for the convertible note debt market.

NOTES

1. See Watts & Zimmerman (1986) chapter 11 and 12 for a review of this research.

2. For a review of these events, see e.g. Chambers (1964) and Birkett & Walker (1971).

3. See Australian Society of Accountants (1966).

4. When funds were transfered to non guarantor companies, the trustee did not have recourse to the assets of these companies as the advances were unsecured.

5. The `Public Borrowings Acts' applicable in each State were as follows:

   NSW, Companies (Amendment) Act 1964, Act 20, 1964
   Qld, Companies Act Amendment Act of 1964, Act 10, 1964
   SA, Companies Act Amendment Act 1964, Act 52, 1964
   Tas, Companies Act 1966, Act 28, 1966
   Vic, Companies (Public Borrowings) Act 1963, Act 7089
   WA, Companies Act Amendment Act 1964, Act 69, 1964

6. The Uniform Companies Act in each State was:

   NSW, Companies Act 1961, Act 71, 1961
   Qld, Companies Act 1961, Act 55, 1961
   SA, Companies Act 1962, Act 56, 1962
   Tas, Companies Act 1962, Act 66, 1962
   Vic, Companies Act 1961, Act 6839
   WA, Companies Act 1961, Act 82, 1961

7. References in the text to the Companies Act 1981 are taken from CCH, Australian National Companies and Securities Legislation, 4 Ed, Revised impression Nov 1984]. Where sections of the Uniform Companies Act 1961 are referred to, these are taken from CCH, NSW Companies Act and Regulation, incorporating amendments to February 1976, 2 Ed, 1976.

8. The Income Tax Assessments Act 1936, as amended, does not contain any provisions that would impact on the trust deeds of debt issues.

9. A survey of convertible notes issued (see section 3.1.2 below) revealed that of the 82 known convertible note issues made between 1976 and 1985, 3 issues were made by borrowing corporations.

10. Written requests were also made to 8 companies seeking confirmation of the existence of a trust deed governing their issues. Of these, 4 responded with the requested

information. Of the 13 issues not subject to trust deeds, 3 issues were quoted on the Stock Exchange and 3 were made to existing shareholders on the basis of no application for listing being made. Four of the issues were made as part consideration to a single vendor in relation to business acquisitions and the remaining 3 were made for funding received from associated and related companies. Of the 3 issues quoted on the Stock Exchange, 2 were made by Banks which are governed by the Banking Act regulations. As these two issues were not subject to trust deeds, they were not in the sample examined.

11. The 1976 issue by TNT Ltd was made with no borrowing constraints being imposed. The deed governing this issue was amended in 1983 to cover the issue of the 1983 subordinated convertible notes and incorporated into the amendments was the negative pledge that the company would not issue in Australia, any secured debt unless the equivalent security was extended to holders of the 1976 convertible note issue (but not the 1983 subordinated convertible noteholders).

12. Whittred & Zimmer (1986) adopted the year of listing on the Stock Exchange as the basis of classifying their sample. They reported the sample period to be 1975 to 1983. In this study, the announcement date of the issue is used to classify the sample period as the announcement date is considered to be a closer approximation to the negotiation of the trust deeds than the listing date. This was done in order to obtain a clearer time series analysis of the impact of introduction of standards on the negotiated principles. The sample period of Whittred & Zimmer's study is restated for the purpose of comparison with this study.

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## APPENDIX 1

## CONVERTIBLE NOTE ISSUES 1976 - 1985

### A) SAMPLE OF CONVERTIBLE NOTE TRUST DEEDS EXAMINED

1) 1976 Brick & Pipes Limited
   $1.50 9.5% convertible unsecured notes maturing 1986
   Trust deed copy examined undated 1976

2) 1976 Jennings Industries Limited
   $1.54 10% convertible unsecured notes maturing 1984
   Trust deed dated 9 May 1973

3) 1976 Sabco Limited
   80¢ 12% convertible unsecured notes maturing 1986
   Trust deed dated 24 March 1976

4) 1976 Stock & Holdings Limited
   $1 10.5% convertible unsecured notes maturing 1983
   Trust deed dated 11 July 1972

5) 1976 TNT Limited
   $1.60 9.75% convertible unsecured notes maturing 1985
   Trust deed dated 14 January 1976

6) 1976 Transpec Holdings Limited
   $1 12.5% convertible unsecured notes maturing 1983
   Trust deed dated 28 May 1976

7) 1978 Softwood Holdings Limited
   $2 10.75% convertible unsecured notes maturing 1987
   Trust deed dated 14 May 1975

8) 1979 Acmil Limited
   80¢ 12.5% convertible unsecured notes maturing 1985
   Trust deed dated 20 December 1979

9) 1979 Pioneer Concrete Services Limited
   $1.85 10.75% convertible unsecured notes maturing 1989
   Trust deed dated 27 June 1979

10) 1979 Stock & Holdings Limited
   $1 10% convertible unsecured notes maturing 1986
   Trust deed dated 11 July 1972

11) 1980 APM Limited
   $2.25 11% convertible unsecured notes maturing 1990
   Trust deed dated 29 August 1980

12) 1980 Ampol Petroleum Limited
   $1.30 11.25% convertible unsecured notes maturing 1990
   Trust deed dated 27 February 1980

13) 1980 Australian National Industries Limited
$3.10 11% convertible unsecured notes maturing 1991
Trust deed dated 24 September 1980

14) 1980 Brambles Industries Limited
$2 12.5% convertible unsecured notes maturing 1985
Trust deed dated 30 April 1973

15) 1980 CSR Limited
$8.25 8% convertible unsecured notes maturing 1991
Trust deed dated 3 December 1980

16) 1980 Clyde Industries Limited
$3 11% convertible unsecured notes maturing 1990
Trust deed dated 22 December 1980

17) 1980 Jennings Industries Limited
$1.15 11.5% convertible unsecured notes maturing 1991
Trust deed dated 9 May 1973

18) 1980 John Perry Limited
$2.80 11.25% convertible unsecured notes maturing 1991
Trust deed dated 3 November 1980

19) 1980 Petersville Australia Limited
$1.35 10.75% convertible unsecured notes maturing 1991
Trust deed dated 10 December 1980

20) 1980 Softwood Holdings Limited
$2.75 11.75% convertible unsecured notes maturing 1988
Trust deed dated 14 May 1975

21) 1981 Bradmill Industries Limited
85¢ 13% subordinated convertible unsecured notes maturing 1991
Trust deed dated 20 August 1981

22) 1981 Defiance Mills Limited
$1.10 12.5% convertible unsecured notes maturing 1989
Trust deed dated 3 June 1981

23) 1981 Edwards Dunlop & Co Ltd
$2.65 11% convertible unsecured notes maturing 1991
Trust deed dated 3 January 1981

24) 1981 Enacon Limited
$1.35 12.5% convertible unsecured notes maturing 1991
Trust deed dated 6 November 1981

25) 1981 Evans Deakin Industries Limited
$2.20 11.5% convertible unsecured notes maturing 1991
Trust deed dated 29 June 1981

26) 1981 F H Fauldings & Co Limited
$1.55 13% convertible unsecured notes maturing 1991
Trust deed dated 29 September 1981

27) 1981 Fielders Gillespie Limited
$1.07 12% convertible unsecured notes maturing 1991
Trust deed dated 6 January 1981

28) 1981 James Hardie Industries Limited
$5 11% convertible unsecured notes maturing 1991
Trust deed dated 16 July 1981

29) 1981 Mayne Nickless Limited
$2.85 11% convertible unsecured notes maturing 1991
Trust deed dated 11 December 1980

30) 1981 McIlwraith-Davey Industries Limited
$3 11% convertible unsecured notes maturing 1991
Trust deed dated 19 February 1981

31) 1981 Whittakers Limited
$1.30 14.5% convertible unsecured notes maturing 1991
Trust deed dated 28 September 1981

32) 1981 Woolworths Limited
$2 12% convertible unsecured notes maturing 1991
Trust deed dated 27 May 1981

33) 1981 Wormald International Limited
$3.65 12.25% convertible unsecured notes maturing 1991
Trust deed dated 22 June 1981

34) 1982 Brambles Industries Limited
$2.05 15% convertible unsecured notes maturing 1990
Trust deed dated 29 July 1982

35) 1982 Bristile Ltd
$1.30 14.5% convertible unsecured notes maturing 1991
Trust deed dated 16 March 1982

36) 1982 Queensland Press Limited
$3.25 14% convertible unsecured notes maturing 1993
Trust deed dated 27 August 1982

37) 1983 Bristile Ltd
$1.20 16.2% subordinated convertible unsecured notes maturing 1993
Trust deed dated 16 March 1982

38) 1983 Palings Hayward Group Limited
$1 14% convertible unsecured notes maturing 1988
Trust deed dated 2 November 1983

39) 1983 Repco Corporation Limited
$1.10 13% subordinated convertible unsecured notes maturing 1992
Trust deed dated 6 June 1983

40) 1983 Sabco Limited
$1.15 12% convertible unsecured notes maturing 1993
Trust deed dated 3 March 1983

41) 1983 Siddons Industries Limited
$1.35 13% convertible unsecured notes maturing 1993
Trust deed dated 27 June 1983

42) 1983 TNT Limited
$2.15 10.5% convertible subordinated unsecured notes maturing 1993
Trust deeds dated 14 January 1976, 12 August 1983 & 24 August 1983

43) 1984 Enterprise Investments (South Australia) Limited
$1 13.75% convertible unsecured notes maturing 1989
Trust deed dated 25 October 1984

44) 1985 BT Insurance (Holdings) Limited
$1 12.5% convertible unsecured notes maturing 1990
Trust deed dated 23 May 1985

45) 1985 G J Coles Limited
$4.50 13% convertible unsecured notes maturing 1992
Trust deed dated 2 September 1985

**B) SAMPLE OF EXTRACTS OF TRUST DEEDS EXAMINED**

1) 1976 Hungerford Hills Limited
$1.20 10.5% convertible unsecured notes maturing 1983
Trust deed dated 26 May 1976

2) 1976 E A Watts Holdings Limited
50¢ 12.5% convertible unsecured notes maturing 1981
Trust deed dated 17 June 1976

3) 1980 Grace Brothers Holdings Limited
$2.25 11% convertible unsecured notes maturing 1991
Trust deed dated 24 October 1980

4) 1980 Lifesavers Australia Limited
$2.70 12% convertible unsecured notes maturing 1990
Trust deed dated 11 November 1980

5) 1980 Warburton O'Donnell Limited
$2.50 12% convertible unsecured notes maturing 1990
Trust deed dated 15 November 1973

6) 1981 Comeng Holdings Limited
$4 11% convertible unsecured notes maturing 1991
Trust deed dated 21 January 1981

7) 1981 Davis Consolidated Industries Limited
$2.80 12.5% convertible unsecured notes maturing 1991
Trust deed dated 2 February 1981

8) 1981 International Combustion Australia Limited
$4 12.5% convertible unsecured notes maturing 1991
Trust deed dated 24 August 1981

9) 1982 Industrial Engineering Limited
$3 12% convertible unsecured notes maturing 1992
Trust deed dated 21 January 1982

10) 1982 Meacham Leyland Holdings Limited
$1 15% convertible unsecured notes maturing 1985
Trust deed dated 20 January 1982

11) 1982 Wilkinson Day & Grimes Limited
80¢ 15% convertible unsecured notes maturing 1987
Trust deed dated 27 April 1982

12) 1984 Jennings Industries Limited
$1.65 11.25% convertible subordinated unsecured notes maturing 1994
Trust deed dated 2 April 1984

13) 1984 Kresta Blinds (Holdings) Limited
60¢ 14.5% convertible subordinated unsecured notes maturing 1989
Trust deed dated 5 October 1984

**C) ISSUES WITH TRUST DEEDS NOT AVAILABLE FOR EXAMINATION**

1) 1976 Barrett Burton (Australia) Limited
$1.25 11% convertible unsecured notes maturing 1984
Trust deed dated ?

2) 1976 Parrys Department Stores Limited
$1.50 11% convertible unsecured notes maturing 1981
Trust deed dated 27 June 1976

3) 1978 Metro Meat Limited
$1 11% convertible unsecured notes maturing 1986
Trust deed dated x March 1978

4) 1978 Olympic Consolidated Industries Limited
50¢ 11% convertible unsecured notes 1988
Trust deed dated 30 May 1978

5) 1980 B Seppett & Sons Limited
$1.60 11% convertible unsecured notes maturing 1990
Trust deed dated ?

6) 1981 Metro Meat Limited
$1.15 12.5% convertible unsecured notes maturing 1988
Trust deed dated ?

7) 1981 Myer Emporium Limited
$2.20 11.25% convertible unsecured notes maturing 1992
Trust deed dated 20 July 1981

8) 1982 Besser (Queensland) Limited
$2.50 12.5% convertible unsecured notes maturing 1989
Trust deed dated 22 December 1981

9) 1983 Myer Emporium Limited
$1.50 14% convertible unsecured notes maturing 1994
Trust deed dated 20 July 1981

10) 1985 Linter Group Limited
$4.90 10% convertible subordinated unsecured notes maturing 1995
Trust deed dated ?

11) 1985 Pacific Mutual Australia Limited
$1 12.75% convertible subordinated unsecured notes maturing 1994
Trust deeds dated 17 December 1984 & 4 June 1985

## D) ISSUES NOT SUBJECT TO TRUST DEEDS

1) 1978 CBC of Sydney Limited
$2.25 10% convertible unsecured notes maturing 1988

2) 1980 Austen & Butta Limited
$4 11% convertible unsecured notes maturing 1989

3) 1981 Korvest Limited
50¢ 14% convertible unsecured notes maturing 1988

4) 1981 TNT Limited
$2.75 10% convertible unsecured notes maturing 1990

5) 1982 Mascot Industries LImited
$1 14.5% convertible unsecured notes maturing 1986

6) 1982 Pioneer Homes Limited
20¢ 18% convertible unsecured notes maturing 1985

7) 1983 Jack Chia (Australia) Limited
$1 13% convertible subordinated unsescured notes maturing 1989

8) 1983 Defender Australia Limited
$1 13% convertible unsecured notes maturing 1988

9) 1984 ATS Resources Limited
$1 12% convertible unsecured notes maturing 1987

10) 1984 Mercantile Credits Limited
$1 13% convertible unsecured notes maturing 1990

11) 1984 National Australia Bank Limited
$3.40 10% convertible unsecured notes maturing 1993

12) 1984 Selected Securities Limited
$2 14% convertible unsecured notes maturing 1988

13) 1985 Australian Farming Properties Limited
US$1 10.25% convertible bonds maturing 1992

APPENDIX 2

## ILLUSTRATION OF THE IMPACT OF CHANGE IN DEFINITION OF THE GROUP ON TREATMENT OF NON-GUARANTOR RELATED COMPANY ITEMS

| | Company & guarantors (excluding NGR co items) | Non-guarantor related company (NGR co) |
|---|---|---|
| Assume: | | |
| Tangible assets (TA) | $ 1000 | $ 500 |
| Total liabilities (TEL) | 600 | 300 |
| Net tangible assets (NTA) | 400 | 200 |
| Liabilities to assets ratio | 60% | 60% |

Assuming NTA of Non-guarantor company (NGR Co) = value of investment and there are no inter-company advances, the accounting of the investment is as follows:

| | Group defined as Company & guarantors | Group defined as Company & subsidiaries |
|---|---|---|
| Basis of accounting of investment in NGR co | Investment not consolidated but treated as assets. | Fully consolidated |
| Consolidated Accounts of the Group | | |
| Total assets | 1000 + 200 = 1200 | 1000 + 500 = 1500 |
| Total liabilities | 600 + 0 = 600 | 600 + 300 = 900 |
| Liabilities to assets ratio | 50% | 60% |

**Impact of change in definition of Group**

The liabilities to assets ratio computed based on full consolidation of the investment in non-guarantor related company is higher than that based on accounting for it as an investment.

**Conclusion**

The change to the `broader' definition of the Group based on the company & subsidiaries has not resulted in a less stringent liability limitation constraint.

## TABLE 1

### CONVERTIBLE NOTE ISSUES 1976 - 1985
### DETAILS OF AVAILABILITY OF TRUST DEEDS OR EXTRACTS THEREOF

| | | | | | | Calender year | | | | | |
|---|---|---|---|---|---|---|---|---|---|---|---|
| | TOTAL | 1985 | 1984 | 1983 | 1982 | 1981 | 1980 | 1979 | 1978 | 1977 | 1976 |
| **Known Convertible Note Issues** | | | | | | | | | | | |
| Number of issues | 82 | 5 | 7 | 9 | 9 | 20 | 15 | 3 | 4 | - | 10 |
| Less: Issues known not to be subject to trust deeds | 13 | 1 | 4 | 2 | 2 | 2 | 1 | - | 1 | - | - |
| Issues for which trust deeds are known to exist | 69 | 4 | 3 | 7 | 7 | 18 | 14 | 3 | 3 | - | 10 |
| **Availability of trust deeds** | | | | | | | | | | | |
| Trust deeds available | 45 | 2 | 1 | 6 | 3 | 13 | 10 | 3 | 1 | - | 6 |
| Extracts of trust deeds available | 13 | - | 2 | - | 3 | 3 | 3 | - | - | - | 2 |
| Trust deeds not available | 11 | 2 | - | 1 | 1 | 2 | 1 | - | 2 | - | 2 |
| Issues known to be subject to trust deeds | 69 | 4 | 3 | 7 | 7 | 18 | 14 | 3 | 3 | - | 10 |
| **Overlap of sample with Whittred & Zimmer (1986)** | | | | | | | | | | | |
| Overlapping | 12* | | | | 2 | 4 | - | 2 | - | - | 4 |
| Non-overlapping | 2 | | | | - | - | - | - | 1 | - | 1 |
| Whittred & Zimmer's sample | 14 | | | | 2 | 4 | - | 2 | 1 | - | 5 |

* Of these 9 trust deeds and 3 extracts were examined

TABLE 2

CONVERTIBLE NOTE TRUST DEEDS 1976 - 1985
BORROWING LIMITATION COVENANTS

| Company | Date Issue Announced | Trust Deed Dated | Liability Limitation: Total External Liabilities TEL < % TTA | Liability Limitation: Secured Liabilities SL < % TTA | Maximum Convertible Note Borrowings | Definition of Group: Company & Guarantors | Definition of Group: Company & all Subsidiaries |
|---|---|---|---|---|---|---|---|
| 01 Sabco | 3/76 | 3/76 | 60 | 40 | - | X | - |
| 02 Hungerford Hills | 3/76 | 5/76 | 75 | - | - | X | - |
| 03 Stock & Holdings | 4/76 | 11/72 | 75 | - | - | X | - |
| 04 E A Watts Holdings | 5/76 | 6/76 | 80 * | 40 | - | X | - |
| 05 Brick & Pipes | 6/76 | undated/76 | 60 | 40 | - | X | - |
| 06 TNT | 7/76 | 1/76 | - | - | - | - | - |
| 07 Jennings Industries | 8/76 | 5/73 | 85 | 66.7 | - | X | - |
| 08 Transpec Holdings | 12/76 | 5/76 | 65 | 45 | - | X | - |
| 09 Softwood Holdings | 10/78 | 5/75 | 60 * | - | - | X | - |
| 10 Stock & Holdings | 4/79 | 11/72 | 75 | - | - | X | - |
| 11 Pioneer Concrete | 9/79 | 6/79 | 65 | 15 | - | X | - |
| 12 Acmil | 10/79 | 12/79 | 65 | 40 | - | X | - |
| 13 Ampol Petroleum | 2/80 | 2/80 | 66.7 | 50 | - | X | - |
| 14 Softwood Holdings | 4/80 | 5/75 | 60 * | - | - | X | - |
| 15 Brambles Industries | 6/80 | 4/73 | 60 | 40 | - | X | - |
| 16 APM | 8/80 | 8/80 | 60 | 40 | - | X | - |
| 17 Warburton O'Donnell | 8/80 | 11/80 | 75 | 50 | - | X | - |
| 18 ANI | 9/80 | 9/80 | 75 | 40 | - | X | - |
| 19 Grace Bros | 9/80 | 10/80 | 60 * | 50 | - | X | - |
| 20 John Perry | 10/80 | 11/80 | 70 | 40 | - | X | - |
| 21 Lifesavers Australia | 10/80 | 11/80 | 65 | 40 | - | X | - |
| 22 CSR | 11/80 | 12/80 | 75 * | 66.7 * | - | - | X |
| 23 Clyde Industries | 11/80 | 12/80 | 70 | 40 | - | - | X |
| 24 Jennings Industries | 11/80 | 5/73 | 85 | 66.7 | - | X | - |
| 25 Petersville | 11/80 | 12/80 | 60 | 40 | - | X | - |
| 26 Edwards Dunlop | 12/80 | 1/81 | 70 | 40 | - | - | X |
| 27 Fielders Gillespie | 12/80 | 1/81 | 75 * | 66.7 * | - | - | X |
| 28 Comeng Holdings | 12/80 | 1/81 | 75 | 50 | - | - | X |
| 29 Mayne Nickless | 12/80 | 5/81 | 65 | 10 | - | X | - |
| 30 Davis Consolidated | 1/81 | 2/81 | 70 | 50 | - | - | X |
| 31 McIlwraith Davey | 1/81 | 2/81 | 70 | 45 | - | X | - |
| 32 Woolworths | 4/81 | 5/81 | 70 | 50 | - | - | X |
| 33 Defiance Mills | 5/81 | 6/81 | 75 * | 66.7 * | - | - | X |
| 34 Wormald | 5/81 | 6/81 | 75 * | 50 * | - | - | X |
| 35 Evans Deakin Industries | 6/81 | 6/81 | 75 | 40 | - | - | X |
| 36 James Hardie Industries | 6/81 | 7/81 | 70 | 40 | - | - | X |
| 37 International Combustion | 7/81 | 8/81 | 70 | 40 | - | X | - |
| 38 Bradmill Industries | 8/81 | 8/81 | 65 | 50 | - | - | X |
| 39 F H Fauldings | 9/81 | 9/81 | 70 | 15 | - | X | - |
| 40 Whittakers | 9/81 | 9/81 | 75 * | 66.7 * | - | - | X |
| 41 Enacon | 10/81 | 11/81 | 75 | 50 | - | - | X |
| 42 Industrial Engineering | 12/81 | 1/82 | 75 | 30 | - | - | X |
| 43 Meacham Leyland | 12/81 | 1/82 | 80 | 40 | - | - | X |
| 44 Bristile | 1/82 | 3/82 | 75 * | 66.7 * | - | - | X |
| 45 Wilkinson Day & Grimes | 3/82 | 4/82 | 70 | 40 | - | - | X |
| 46 Brambles Industries | 6/82 | 7/82 | 60 | 40 | - | - | X |
| 47 Queensland Press | 7/82 | 8/82 | 66.7 * | 50 * | - | - | X |
| 48 Sabco | 2/83 | 3/83 | 70 | 40 | - | - | X |
| 49 Repco Corporation | 5/83 | 6/83 | 65 | 40 | note 1 | - | X |
| 50 Siddons Industries | 5/83 | 6/83 | 70 | 40 | - | - | X |
| 51 Bristile | 7/83 | 3/82 | 75 * | 66.7 * | - | - | X |
| 52 TNT | 7/83 | 1/76 | - | - | - | - | - |
| 53 Palings Hayward | 11/83 | 11/83 | 80 * | 66.7 * | note 2 | - | X |
| 54 Jennings Indusries | 3/84 | 4/84 | 85 | 66.7 | - | - | X |
| 55 Kresta Blinds | 10/84 | 10/84 | 80 * | 66.7 * | note 3 | - | X |
| 56 Enterprise Investment | 11/84 | 10/84 | - | - | note 4 | - | - |
| 57 B T Insurance | 4/85 | 5/85 | 75 | 60 | - | - | X |
| 58 G J Coles & Co | 9/85 | 9/85 | 80 | 50 | - | - | X |
| | | | | | | 26 | 29 |

* Denote computation based on times of shareholders funds (SHF)
restated in the table in terms of TTA for comparative purposes.
Note: some of the trust deeds measure TEL relative to SHF and SL relative to TTA.

Notes
Maximum borrowing limitation:
Note 1 : Subordinated debts < 12% of TEL
Note 2 : Notes < 1 time of nominal value of all issued shares + premium paid on these shares
Note 3 : Notes < 1 time of nominal value of all issued shares + premium paid on these shares
Note 4 : Notes < $10 million

## TABLE 3

### CONVERTIBLE NOTE TRUST DEEDS 1976 - 1985
### ANALYSIS OF LIABILITY LIMITATION CONSTRAINTS ACROSS AASE INDUSTRY CLASSIFICATION

**A) Of Deeds defining Group as being that of Company & Guarantors**

| | Number of Trust Deeds | | | | | | | | | | | | | | | |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| | TEL < % TTA | | | | | | | | SL < % TTA | | | | | | | |
| AASE INDUSTRY CLASSIFICATION | 60% | 65% | 66.7% | 70% | 75% | 80% | 85% | TOTAL | 10% | 15% | 40% | 45% | 50% | 66.7% | No Limit | TOTAL |
| Developers & Contractors | - | - | - | - | 2 | 1 | 2 | 5 | - | - | 1 | - | - | 2 | 2 | 5 |
| Builders Supplies | 3 | 2 | - | 1 | - | - | - | 6 | - | 1 | 2 | 1 | - | - | 2 | 6 |
| Electrical & Durables | 1 | - | - | - | 1 | - | - | 2 | - | - | 1 | - | 1 | - | - | 2 |
| Food & Household goods | 1 | 1 | - | 1 | - | - | - | 3 | - | 1 | 2 | - | - | - | - | 3 |
| Heavy Engineering | - | - | - | 2 | 1 | - | - | 3 | - | - | 3 | - | - | - | - | 3 |
| Paper & Packaging | 1 | - | - | - | - | - | - | 1 | - | - | 1 | - | - | - | - | 1 |
| Retail | 1 | - | - | - | - | - | - | 1 | - | - | - | - | 1 | - | - | 1 |
| Transport | 1 | 2 | - | - | - | - | - | 3 | 1 | - | 1 | 1 | - | - | - | 3 |
| Misc Services | - | - | 1 | - | - | - | - | 1 | - | - | - | - | 1 | - | - | 1 |
| Misc & Diversified Industries | - | - | - | - | 1 | - | - | 1 | - | - | - | - | - | - | 1 | 1 |
| Total | 8 | 5 | 1 | 4 | 5 | 1 | 2 | 26 | 1 | 2 | 11 | 2 | 3 | 2 | 5 | 26 |

**B) Of Deeds defining Group as being that of Company & Subsidiaries**

| | Number of Trust Deeds | | | | | | | | | | | | | | |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| | TEL < % TTA | | | | | | | | SL < % TTA | | | | | | |
| AASE INDUSTRY CLASSIFICATION | 60% | 65% | 66.7% | 70% | 75% | 80% | 85% | TOTAL | 10% | 30% | 40% | 50% | 60% | 66.7% | TOTAL |
| Developers & Contractors | - | - | - | - | - | - | 1 | 1 | - | - | - | - | - | 1 | 1 |
| Builders Supplies | - | - | - | 2 | 3 | 1 | - | 6 | - | - | 3 | - | - | 3 | 6 |
| Electrical & Durables | - | - | - | 1 | - | - | - | 1 | - | - | 1 | - | - | - | 1 |
| Food & Household goods | - | - | - | 1 | 2 | - | - | 3 | - | - | - | 1 | - | 2 | 3 |
| Textiles & Clothing | - | 1 | - | - | - | - | - | 1 | - | - | - | 1 | - | - | 1 |
| Automotive | - | 1 | - | - | - | - | - | 1 | - | - | 1 | - | - | - | 1 |
| Light Engineering | - | - | - | 1 | 2 | - | - | 3 | - | 1 | 1 | 1 | - | - | 3 |
| Heavy Engineering | - | - | - | 1 | 2 | - | - | 3 | - | - | 2 | 1 | - | - | 3 |
| Paper & Packaging | - | - | - | 1 | - | - | - | 1 | - | - | 1 | - | - | - | 1 |
| Insurance | - | - | - | - | 1 | - | - | 1 | - | - | - | - | 1 | - | 1 |
| Retail | - | - | - | 1 | - | 3 | - | 4 | - | - | - | 2 | - | 2 | 4 |
| Transport | 1 | - | - | - | - | - | - | 1 | - | - | 1 | - | - | - | 1 |
| Media | - | - | 1 | - | - | - | - | 1 | - | - | - | 1 | - | - | 1 |
| Misc & Diversified Industries | - | - | - | - | 1 | - | - | 1 | - | - | - | 1 | - | - | 1 |
| Diversified Resources | - | - | - | - | 1 | - | - | 1 | - | - | - | - | - | 1 | 1 |
| Total | 1 | 2 | 1 | 8 | 12 | 4 | 1 | 29 | - | 1 | 10 | 8 | 1 | 9 | 29 |

**TABLE 4**

**CONVERTIBLE NOTE TRUST DEEDS 1976 - 1985**
**CROSS-SECTIONAL VARIATION IN LIABILITY LIMITATION CONSTRAINTS**
**BY DEFINITION OF GROUP UTILISED FOR COMPUTATION OF THE LIABILITY LIMITATION**

| | Total Sample | Secured Liabilities SL < % TTA | | | Total External Liabilities TEL < % TTA | | |
|---|---|---|---|---|---|---|---|
| | | Mean | Median | Mode | Mean | Median | Mode |
| Convertible Note issues defining Group as: | | | | | | | |
| - Company & Guarantors | 26 | 52 | 40 | 40 | 68 | 66 | 60 |
| - Company & Subsidiaries | 29 | 51 | 50 | 40 | 73 | 75 | 75 |
| Mann-Whitney U-test of differences in Group definintion: z-statistic | | | 0.847 a | | | 2.611 b | |

a not significant at .10

b significant at .09

**TABLE 5**

**CONVERTIBLE NOTE TRUST DEEDS 1976 - 1985**
**REPORTING OBLIGATIONS**

| | Number of Trust Deeds | | % of Trust Deeds (n = 45) | |
|---|---|---|---|---|
| **A) Report of Financial Position to Trustees** | | | | |
| i) Annual Accounts | | 45 | | 100% |
| ii) Half yearly accounts | | | | |
| - required each year | 27 | | 60% | |
| - only where statutory requirement exists to prepare them | 3 | | 7% | |
| - only where statutory requirement exists to prepare them or when loss incurrred in previous year | 2 | | 4% | |
| | | 32 | | 71% |
| iii) At the request of trustees | | 24 | | 53% |
| **B) Reporting of Creation of Charges to Trustees** | | 12 | | 27% |
| **C) Report of Compliance with Trust Deed to Trustees** | | | | |
| i) Quarterly report by directors | | 43 | | 96% |
| ii) Report by auditors | | | | |
| a) annual report | | 39 | | 87% |
| b) half yearly report | | | | |
| - required each year | 23 | | 51% | |
| - only if accounts are audited | 4 | | 9% | |
| - only if accounts are required | 3 | | 7% | |
| | | 30 | | 67% |
| c) at the request of trustees | | 16 | | 36% |
| iii) Report by Directors | | | | |
| - annual and half yearly | | 5 * | | 11% |
| - half yearly only | 3 | | 7% | |
| - only if half yearly accounts are unaudited | 2 | | 4% | |
| | | 5 * | | 11% |
| - at the request of trustees | | 4 | | 9% |

* In 6 of the 10 half yearly reports, the directors have to advise whether there are any change in accounting policies made during the period.

## TABLE 6

### CONVERTIBLE NOTE TRUST DEEDS 1976 - 1985
### 'UPDATING' ADJUSTMENTS TO ACCOUNTING DEFINITIONS IN LIABILITY LIMITATION CONSTRAINTS

| | Total Tangible Assets | Total External Liabilities | Shareholders Funds |
|---|---|---|---|
| Number of times defined in the 55 deeds with borrowing constraints examined | 48 * | 55 | 14 ** |
| **Nature of adjustments for changes since the latest consolidated accounts** | | Number of Deeds*** | |
| 1) New share or debenture issues (including calls) | 40 (35, 5) | - | 6 (5, 1) |
| 2) Proposed share issues that are being underwritten | 33 (28, 5) | - | 5 (4, 1) |
| 3) Share or debenture issues used to discharge liabilities | - | 21 (21, 0) | - |
| 4) New long term borrowings | 33 (28, 5) | 28 (28, 0) | 5 (5, 0) |
| 5) Changes in status of guarantor/subsidiary companies | 21 (19, 2) | 21 (21, 0) | 1 (1, 0) |
| 6) Total tangible assets/(Total external liabilities) of a company which the borrowing company or guarantor company is entitled to acquire 100% of share capital | 19 (9, 10) | 16 (16, 0) | - |
| 7) External borrowings since repaid. | 1 (1, 0) | 1 ( 1, 0) | - |
| 8) Assets/(Borrowings) used to acquire a company which has since become a guarantor/subsidiary company | 5 (5, 0) | 3 ( 3, 0) | - |
| 9) Any material changes | 7 (7, 0) | 12 (12, 0) | 5 (5, 0) |

* Included were 7 deeds where total tangible assets were not defined, as the liability limitation constraints were computed in terms of shareholders funds.

** Included were 7 cases of the definition of shareholders funds being total tangible assets less total external liabilities

*** Figures in parenthesis - the first-mentioned figure is the number of deeds where the adjustments are compulsory, while the second-mentioned figure is the number of deeds where the adjustments are at the option of the company.

TABLE 7

CONVERTIBLE NOTE TRUST DEEDS 1976 - 1985
AUDITORS' ADJUSTMENTS TO ACCOUNTING DEFINITIONS
USED IN LIABILITY LIMITATION CONSTRAINTS

| | Number of Trust Deeds | | % of Trust Deeds | |
|---|---|---|---|---|
| **TOTAL TANGIBLE ASSETS** | | | | (n = 48) |
| Ascertainment of | | | | |
| a) intangible assets to be excluded from computation | | 26 | | 54% |
| b) material changes since the date of the latest consolidated accounts | | 4 | | 8% |
| c) deduction of certain provisions in the latest consolidated accounts from the computation | | 3 | | 6% |
| Discretionary power to adjust based on | | | | |
| - Generally accepted accounting principles | 21 | | 44% | |
| - auditors' opinion | 21 | | 44% | |
| | | 42 | | 88% |
| **TOTAL EXTERNAL LIABILITIES** | | | | (n = 55) |
| Ascertainment of | | | | |
| a) inclusion of contingent liabilities | | 17 | | 31% |
| b) material changes since the date of the latest consolidated accounts | | 12 | | 22% |
| Discretionary power to adjust based on | | | | |
| - Generally accepted accounting principles | 24 | | 44% | |
| - auditors' opinion | 25 | | 45% | |
| | | 49 | | 89% |
| **SHAREHOLDERS FUNDS** | | | | (n = 14) |
| Ascertainment of | | | | |
| a) material changes since the date of the latest consolidated accounts | | 4 | | 29% |
| Discretionary power to adjust based on | | | | |
| - Generally accepted accounting principles | 8 | | 57% | |
| - auditors' opinion | 3 | | 21% | |
| | | 11 | | 78% |

## TABLE 8

### CONVERTIBLE NOTE TRUST DEEDS 1976 - 1985
### NEGOTIATED TREATMENT OF NON-GUARANTOR RELATED COMPANY ITEMS
### USED IN LIABILITY LIMITATION CONSTRAINTS

| | No of Trust Deeds | | % of Trust Deeds | |
|---|---|---|---|---|
| In respect of consolidation of company and guarantors, treatment of non-guarantor related company items: | | | (n = 26) | |
| INVESTMENTS | | | | |
| i) Exclude the whole of the amount of investments in such companies | 11 | | 42% | |
| ii) Include an amount of investments which is different from the AASE requirements | | | | |
| - higher amount | 6 | | 23% | |
| | | 17 | | 65% |
| ADVANCES | | | | |
| i) Exclude the whole of the amount of advances to such companies | 9 | | 35% | |
| iv) Include an amount of advances which is different from the AASE requirements | | | | |
| - higher amount | 9 | | 35% | |
| - lower amount | 5 | | 18% | |
| | | 23 | | 88% |

TABLE 9

**CONVERTIBLE NOTE TRUST DEEDS 1976 - 1985**
**NEGOTIATED ADJUSTMENTS TO ACCOUNTING DEFINITIONS**
**USED IN COMPUTATION OF LIABILITY LIMITATION CONSTRAINTS**

| | No of Trust Deeds | % of Trust Deeds |
|---|---|---|
| **DEFINITION OF TOTAL TANGIBLE ASSETS** | | |
| Adjustments in defined base: | | (N = 48) |
| a) Deduct uncalled liabilities in respect of any shares beneficially held by the company and guarantor companies | 1 | 2% |
| b) Include the amount of any uncalled liability on partly paid shares issued by the company and the balance (if any) of any monies remaining to be paid by instalments to the company by any debenture stockholder in respect of debenture stock issued by the company | 1 | 2% |
| **DEFINITION OF TOTAL EXTERNAL LIABILITIES** | | (n = 55) |
| Adjustments in defined base: | | |
| a) Exclude convertible notes and subordinated notes | 5 | 9% |
| b) Exclude liabilities wholly charged on assets situated overseas | 1 | 2% |
| c) Include redeemable preference shares, redeemable longer than 12 months | 1 | 2% |
| d) Include minority interest in guarantor subsidiaries | 1 | 2% |
| e) Include liabilities of non-guarantor related companies which have been guaranteed by the company and guarantors | 1 | 2% |
| f) Include amount of debenture stock not covered by the debenture stock redemption fund. (The equivalent amount of the redemption fund is to be deducted from total tangible assets and total external liabilities | 1 | 2% |
| **DEFINITION OF SHAREHOLDERS FUND** | | (n = 14) |
| Adjustments in defined base: | | |
| a) Exclude Intangible Assets | 14 | 100% |
| b) Exclude debit balance in profit & loss appropriation account | 1 | 7% |
| c) Include convertible notes and subordinated notes | 1 | 7% |

TABLE 10

CONVERTIBLE NOTE TRUST DEEDS 1976 - 1985
CORRESPONDENCE OF NEGOTIATED ADJUSTMENTS IN ACCOUNTING PRINCIPLES WITH ACCOUNTING STANDARDS

| | No of Trust Deeds | % of Trust Deeds |
|---|---|---|
| **STANDARDS MODIFIED** | | (n = 55) |
| Deferred Tax (AAS 3) | | |
| a) Exclude provision for deferred tax from total liabilities | 10 | 18% |
| b) Add to total tangible assets, an amount equal to the future tax liability appearing in the balance sheet | 1 | 2% |
| Depreciation (AAS 4) | | |
| Write back of depreciation charged against profit in excess of tax allowable deduction to total tangible assets | 10 | 18% |
| Lease Accounting (AAS 17/ASRB 1008) | | |
| a) Exclude from amount of total external liabilities, any liability (whether contingent or actual) which is of the nature of lease rental or of a similar nature not yet due and payable | 2 | 4% |
| b) Disregard leases of freehold properties (but not disregarding leasehold improvements described as fixed assets) which may be capitalised pursuant to any accounting standards | 1 | 2% |
| **NEGOTIATED PRINCIPLES OUTSIDE STANDARDS** | | |
| Revaluation (AAS 10) | | |
| a) Revaluation to be performed by independent valuer | 45 | 82% |
| a) Specified minimum unexpired term of leasehold properties (between 10 to 20 years) before revaluation can be taken into account in the borrowing limitation computation | 6 | 11% |
| b) Revaluation need not be recorded in the books of accounts | 9 | 16% |
| Equity Accounting (AAS 14) | | |
| a) In respect of investments that have been equity accounted, deduct the amount of write up in excess of underlying net tangible assets of the investment | 1 | 2% |
| b) Add proportionate % of total tangible assets & total external liabilities of any non-guarantor related company | 1 | 2% |
| c) Add 87.5% of the underlying net tangible assets of unquoted non-quarantor non-related companies, subject to a maximum of 45% of the Group's total tangible assets | 1 | 2% |
| **NEGOTIATED PRINCIPLES NOT SUBJECT TO STANDARDS** | | |
| Valuation of Quoted Investments | | |
| Valuation at lower of market value and book value | 11 | 20% |
| Contingent Liabilities | | |
| a) Exclude only contingent liabilities under guarantees in respect of company and subsidiary companies that are guarantors | 1 | 2% |
| b) Exclude contingent liabilities that are reflected as provision for contingencies in the last balance sheet | 6 | 11% |
| c) Exclude contingent liabilities and provision for contingencies | 6 | 11% |
| d) Include percentage only of contingent liabilities pursuant to guarantees | 2 | 4% |
| e) Include only contingencies in respect of guarantees for non-guarantor related companies | 1 | 2% |
| f) Include only if auditors consider provision for contingencies to be necessary | 17 | 31% |
| Provisions including bad & doubtful debts, long service leave, losses & amortisations | | |
| a) Write back of provisions in excess of tax allowances | 3 | 5% |
| b) Write back of amortisation charged against revenue | 2 | 4% |
| c) Include provision for long service leave | 33 | 60% |
| d) Include adequate provision for bad & doubtful debts, losses and amortisation | 41 | 75% |
| Unearned Income | | |
| a) Exclude income yet to mature | 30 | 55% |

TABLE 11

CONVERTIBLE NOTE TRUST DEEDS 1976 - 1985
CORRESPONDENCE OF ALL ACCOUNTING STANDARDS WITH NEGOTIATED PRINCIPLES

| | Standard modified in at least one deed | Principles outside the Standard in all deeds | Entirely consistent in all deeds | Standard not referred to in all deeds |
|---|---|---|---|---|
| Profit & Loss Account - AAS 1 | - | - | - | X |
| Inventory valuation - AAS 2 | - | - | - | X |
| Deferred taxation - AAS 3 | X | - | - | - |
| Depreciation - AAS 4 | X | - | - | - |
| Materiality - AAS 5 | - | - | - | X |
| Accounting policies disclosure - AAS 6 / ASRB 1001 | - | - | - | X |
| Extractive industries - AAS 7 | - | - | - | X |
| Post balance sheet events - AAS 8 / ASRB 1002 | - | - | X | - |
| Expenditure carried forward - AAS 9 | - | - | X | - |
| Revaluation - AAS 10 | - | X | - | - |
| Construction contracts - AAS 11 | - | - | - | X |
| Fund Statement - AAS 12/ ASRB 1007 | - | - | - | X |
| Research & Development - AAS 13 | - | - | - | X |
| Equity accounting - AAS 14 | - | X | - | - |
| Disclosure of Revenue - AAS 15 / ASRB 1004 | - | - | - | X |
| Segment Reporting - AAS 16 / ASRB 1005 | - | - | - | X |
| Leases - AAS 17 / ASRB 1008 | X | - | - | - |
| Goodwill - AAS 18 | - | - | X | - |
| Joint arrangements - AAS 19 / ASRB 1006 | - | - | - | X |
| Foreign currency translation - AAS 20 / ASRB1003 | - | - | - | X |
| Business combinations - AAS 21 | - | - | - | X |
| Accounting for Leveraged leases - ED | - | - | - | X |
| | 3 | 2 | 3 | 14 |

TABLE 12

CONVERTIBLE NOTE TRUST DEEDS 1976 - 1985
CORRESPONDENCE OF NEGOTIATED ACCOUNTING PRINCIPLES WITH THE INTRODUCTION OF ACCOUNTING STANDARDS

| | ** TOTAL | No. of deeds wherein the accounting principles were changed in the year of introduction of accounting standard/exposure drafts/discussion paper — Calender year 1985 | 1984 | 1983 | 1982 | 1981 | 1980 | 1979 | 1978 | 1977 | 1976 | Standards issued prior to 1976 |
|---|---|---|---|---|---|---|---|---|---|---|---|---|
| Profit & Loss Account - AAS 1 | - | - | - | - | - | - | - | - | - | - | - | ( s73) |
| Inventory valuation - AAS 2 | - | - | - | - | - | - | - | - | - | - | - ( s76) | ( s63) |
| Deferred taxation - AAS 3 | 11 | - | 1 | 1 | 2 | 4 (ed81) | 2 | - | - (sa78) | - | 1 (sa76) | ( s70 & s74) |
| Depreciation - AAS 4 | 10 | - | 1 | 2 | 2 | - | 3 | - | - | - | 2 | ( s70 & s74) |
| Materiality - AAS 5 | - | - | - (sa84) | - | - | - | - | - | - | - | - | ( s69 & s74) |
| Accounting policies disclosure - AAS 6 / ASRB 1001 | - | - (AS85) * | - | - | - | - | - | - | - | - (sa77) | - | ( s74) |
| Extractive industries - AAS 7 | - | - | - | - | - | - | - | - | - | - ( s77) | - | |
| Post balance sheet events - AAS 8 / ASRB 1002 | - | - (AS85) | - | - | - | - | - | - | - ( s78) | - | - | |
| Expenditure carried forward - AAS 9 | - | - | - | - (sa83) | - | - | - | - | - | - | - | ( s72) |
| Revaluation - AAS 10 | 15 | - | 1 | 1 (sa83) | 3 | 5 ( s81) | 2 | 2 (ed79) | - | - | 1 | |
| Construction contracts - AAS 11 | - | - | - | - ( s83) | - (ed82) | - | - | - | - | - | - | |
| Fund Statement - AAS 12/ ASRB 1007 | - | - (sa85) | - | - ( s83) | - | - | - | - | - | - | - | |
| Research & Development - AAS 13 | - | - | - | - ( s83) | - (ed82) | - | - | - | - | - | - | |
| Equity accounting - AAS 14 | 3 | - | - (sa84) | - ( s83) | - | 1 | 1 | - (ed79) | - | - | 1 | (ed73) |
| Disclosure of Revenue - AAS 15 / ASRB 1004 | - | - | - ( s84) | - | - | - | - | - | - | - | - | |
| Segment Reporting - AAS 16 / ASRB 1005 | - | - | - ( s84) | - (ed83) | - | - | - | - | - | - | - | |
| Leases - AAS 17 / ASRB 1008 | 3 | 1 | - ( s84) | - (dp83) | - | - (ed81) | 2 (ed80) | - (dp79) | - | - | - | (dp65) |
| Goodwill - AAS 18 | - | - | - ( s84) | - (ed83) | - | - | - | - | - | - | - | |
| Joint arrangements - AAS 19 / ASRB 1006 | - | - ( s85) | - (ed84) | - | - | - | - | - (ed79) | - | - | - | |
| Foreign currency translation - AAS 20 / ASRB1003 | - | - (AS & s85) | - | - (ed83) | - | - | - | - | - | - | - | |
| Business combination - AAS 21 | - | - ( s85) | - (dp84) | - | - | - | - | - | - | - | - | |
| Accounting for Leveraged leases - ED | - | - | - | - | - | - (ed81) | - | - | - | - | - | |
| | 42 | 1 | 3 | 4 | 7 | 10 | 10 | 2 | - | - | 5 | |

* Year of introduction of

AS = ASRB standard
dp = Discussion paper by AARF
ed = Exposure draft
s = AAS standard
sa = AAS standard amended

** From Table 10

## TABLE 13

**SAMPLE OF CONVERTIBLE NOTE TRUST DEEDS IN WHITTRED & ZIMMER (1986)
DEFINITION OF GROUP USED FOR BORROWING CONSTRAINT COMPUTATION
RE-ANALYSED BY DATE OF ANNOUNCEMENT OF ISSUES**

| | Date Issue Announced | Date of Deed | + Year Listed | Definition of Group: Company & Guarantors | Definition of Group: Company & Subsidiaries |
|---|---|---|---|---|---|
| Kemtron | - | 3/74 | 1975 | X | |
| Sabco | 3/76 | 5/76 | 1976 * | X | |
| Hungerford Hill | 3/76 | 6/76 | 1977 | X | |
| Watts Holdings | 5/76 | 6/76 | 1976 * | X | |
| Brick & Pipes | 6/76 | x/76 | 1976 * | X | |
| Parry Dept Stores | 7/76 | 6/76 | 1976 * | X | |
| Metro Meat | 3/78 | 3/78 | 1978 * | X | |
| Pioneer Concrete Services | 9/79 | 6/79 | 1980 * | X | |
| Acmil | 10/79 | 12/79 | 1980 | X | |
| Comeng Holdings | 12/80 | 1/81 | 1981 * | | X |
| Fielders Gillespie | 12/80 | 1/81 | 1981 | | X |
| Defiance Mills | 5/81 | 6/81 | 1981 * | | X |
| Enacon | 10/81 | 11/81 | 1982 * | | X |
| Bristile | 1/82 | 3/82 | 1982 * | | X |
| Queensland Press | 7/82 | 8/82 | 1982 * | | X |

\+ Year of listing extracted from
Sydney Stock Exchange Investment Review Service,
* Indicates date differing from W & Z.

TABLE 14

COMPARATIVE TABLE OF ACCOUNTING STANDARDS EVALUATED TO HAVE BEEN MODIFIED
BY WHITTRED & ZIMMER'S STUDIES AND THIS STUDY

| | W & Z (1984) | | W & Z (1985) | | W & Z (1986) | | THIS STUDY | | | |
|---|---|---|---|---|---|---|---|---|---|---|
| | Standard modified | Entirely consistent | Standard modified | Entirely consistent | Standard modified | Entirely consistent | Standard modified | Rule outside the Standard | Entirely consistent | Standard not referred to |
| **MEASUREMENT STANDARDS** | | | | | | | | | | |
| Profit & Loss Account - AAS 1 | - | X | - | X | ne | ne | - | - | - | X |
| Inventory valuation - AAS 2 | - | X | - | X | ne | ne | - | - | - | X |
| Deferred taxation - AAS 3 | X | - | X | - | X | - | X | - | - | - |
| Depreciation - AAS 4 | - | X | X | - | X | - | X | - | - | - |
| Extractive industries - AAS 7 | ? | - | - | X | X | - | - | - | - | X |
| Post balance sheet events - AAS 8 / ASRB 1002 | X | - | X | - | ne | ne | - | - | X | - |
| Expenditure carried forward - AAS 9 | X | - | X | - | X | - | - | - | X | - |
| Revaluation - AAS 10 | X | - | X | - | ne | ne | - | X | - | - |
| Construction contracts - AAS 11 | - | X | - | X | ne | ne | - | - | - | X |
| Research & Development - AAS 13 | X | - | X | - | X | - | - | - | - | X |
| Equity accounting - AAS 14 | X | - | X | - | ne | ne | - | X | - | - |
| Leases - AAS 17 / ASRB 1008 | - | X | - | X | ne | ne | X | - | - | - |
| Goodwill - AAS 18 | X | - | X | - | X | - | - | - | X | - |
| Joint arrangements - AAS 19 / ASRB 1006 | X | - | ne | ne | ne | ne | - | - | - | X |
| Foreign currency translation - AAS 20 / ASRB1003 | X | - | X | - | ne | ne | - | - | - | X |
| Business combinations - AAS 21 | X | - | ne | ne | ne | ne | - | - | - | X |
| Accounting for Leveraged leases - ED | - | X | ne | ne | ne | ne | - | - | - | X |
| 17 Measurement standards | 11 | 6 | 9 | 5 | 6 | ne | 3 | 2 | 3 | 9 |
| **REPORTING STANDARDS** | | | | | | | | | | |
| Materiality - AAS 5 | - | X | ne | ne | ne | ne | - | - | - | X |
| Accounting policies disclosure - AAS 6 / ASRB 1001 | X | - | ne | ne | ne | ne | - | - | - | X |
| Fund Statement - AAS 12/ ASRB 1007 | - | X | ne | ne | ne | ne | - | - | - | X |
| Disclosure of Revenue - AAS 15 / ASRB 1004 | - | X | ne | ne | ne | ne | - | - | - | X |
| Segment Reporting - AAS 16 / ASRB 1005 | - | X | ne | ne | ne | ne | - | - | - | X |
| 5 Reporting standards | 1 | 4 | ne | ne | ne | ne | - | - | - | 5 |

Key to Table:
X = standard evaluated
ne = standard not evaluated
? = standard commented on but evaluation not made

FIGURE 1

TAXONOMY FOR ASSESSMENT OF NEGOTIATED ACCOUNTING RULES WITH ACCOUNTING STANDARDS