REPORT OF AN ENQUIRY INTO CERTAIN ARRANGEMENTS

ENTERED INTO BY

BANK OF NEW ZEALAND

IN MARCH 1988

SECURITIES COMMIISSION
GREENOCK HOUSE
39 THE TERRACE
P.O. Box 1179
WELLINGTON

Tel: (64)(04) 472-9830
Fax (64)(04) 472-8076

24 MAY 1993

CONTENTS

Page

GLOSSARY OF TERMS (vi)

ALPHABETICAL LISTING OF THOSE REFERRED TO FREQUENTLY IN OUR REPORT (ix)

1. INTRODUCTION 1

Background 1
Proceedings 2
European Pacific Group of Companies. 7
General 8

PART I

ESTABLISHMENT OF THE ARRANGEMENTS

2. BACKGROUND 10

The approval process 11
The parties involved 18
The formal contractual documents 20
The funds flows 21

3. ARE THE ARRANGEMENTS A GENUINE INSURANCE TRANSACTION AT LAW? 25

Do the Insurance Contracts reflect the true agreement between the parties? 25
Are the arrangements a contract of insurance at law? 30

WERE THE PROCEDURES FOR APPROVING THE ARRANGEMENTS ADEQUATE? 55

- The arrangements 55
- Discussions with professional advisers 58
- The role of Buddie Findlay 61
- The payment of fees 63
- The reasons for the Bank entering into the arrangements 64
- The haste to put the arrangements in place 67
- The Commission's findings concerning the approval process 69

CAPTIVE INSURANCE ARRANGEMENTS AND THEIR USE BY BANKS AROUND THE WORLD 72

- General background 72
- The Commission's survey of banks 74
- Overseas comment 75

PART II

THE BANK'S MARCH 1988 FINANCIAL STATEMENTS

6. THE ALLEGATIONS BY MR W.R. PETERS, M.P. 78

7. THE FINANCIAL STATEMENTS OF A BANK 81

8. THE BANK'S MARCH 1988 FINANCIAL STATEMENTS 84

- The financial statements 84
- Our review of the Bank's March 1988 financial statements 85
- Our findings relating to the Bank's March 1988 financial statements 89

PART III

LEGAL AND ACCOUNTING ISSUES RELATING TO THE BANK'S USE OF THE ARRANGEMENTS FROM SEPTEMBER 1988 UNTIL SEPTEMBER 1992

9.	LEGAL RESPONSIBILITIES IN RELATION TO THE TRUTH AND FAIRNESS OF COMPANY ACCOUNTS	90
	Introduction	90
	The responsibilities of directors	90
	The responsibilities of auditors	100
10.	THE APPROPRIATE ACCOUNTING TREATMENT FOR THE ARRANGEMENTS	103
	A framework for determining the appropriate accounting treatment for the arrangements	103
11.	OVERVIEW OF HOW THE BANK HAS USED AND ACCOUNTED FOR THE COSTS AND BENEFITS UNDER THE ARRANGEMENTS FROM SEPTEMBER 1988	116

PART IV

CONSIDERATION OF THE BANK'S PUBLISHED FINANCIAL STATEMENTS FROM SEPTEMBER 1988 ONWARDS

12.	METHODOLOGY OF OUR REVIEW OF EACH SET OF FINANCIAL STATEMENTS	121

13.

14. FINANCIAL YEAR ENDED 31 MARCH 1989

Interim financial statements for the six months ended 31 March 1989

a

	Audited financial statements for the year ended 31 March 1989	139
15.	FINANCIAL YEAR ENDED 31 MARCH 1990	141
	Interim financial statements for the half year ended 30 September 1989	141
	Audited financial statements for the year ended 31 March 1990	143
16.	FINANCIAL YEAR ENDED 31 MARCH 1991	198
	Interim financial statements for the half year ended 30 September 1990	198
	Audited financial statements for the year ended 31 March 1991	201
17.	FINANCIAL YEAR ENDED 31 MARCH 1992	211
	Interim financial statements for the half year ended 30 September 1991	211
	Audited financial statements for the year ended 31 March 1992	214
18.	FINANCIAL YEAR ENDED 31 MARCH 1993	222
	Interim financial statements for the half year ended 30 September 1992	222
19.	DEBT SECURITY PROSPECTUSES ISSUED BY THE BANK UNDER THE SECURITIES ACT 1978	224
	The requirements of the Act and Regulations	224
	Our Review of each Prospectus	
	Prospectus No.1	226
	Prospectus No.2	228
	Prospectus No.3	228
	Prospectus No.4	229
	Prospectus No.5	229
	Prospectus No.8	230
	Prospectus No.7	242
	Prospectus No.8	243
	Prospectus No.9	244

PART V_

MISCELLANEOUS MATTERS

20.FRAUO 246

21.**BREACH** OF **FIOUCIARY** OUTY 246

22. ASPECTS OF THE AOMINISTRATION OF THE ARRANGEMENTS 249

23.REPORTING TO THE RESERVE BANK OF NEW ZEALAND 251

PART VI_

CONCLUSIONS AND REFERRALS_

24. CONCLUSIONS

Nature of arrangements 252
Entry into the arrangements 254
Legal nature of arrangements 257
Use of the arrangements at 31 March 1988 258
Limited use of the arrangements in financial statements in 1988-89 259
More extensive use of the arrangements in 1990 260
Use of the arrangements in the year ended 31 March 1991 265
Use of the arrangements in 1992 and 1993 266
Bank's debt prospectuses 267
The Commission's main concerns 268
Allegations made by Mr W.R Peters, MP 269
Other important manors 270

25. REFERRALS TO OTHER BOOIES 270

Registrar of Companies 270
New Zealand Society of Accountants 271
Reserve Bank of New Zealand 272
Justice Oepartment

APPENOICES

GLO8SARY OF TERM8

ADBRO	ADBRQ investments Limited owned 81% by the Crown and 19% by Fay, Richwhite & Company Limited.
AICPA	American institute of Certified Public Accountants.
BAH	Booz Allen Hamilton, Consultants.
BARiNGS	Baring Brothers Burrows & Co. Limited, Advisers, Sydney.
BOG	BOG Hogg Young Cathie, Chartered Accountants, New Zealand.
BGBW	Bell Gully Buddie Weir, Barristers and Solicitors.
BNZ	Bank of New Zealand.
BNZF	BNZ Finance Limited, a registered bank and listed on the New Zealand Stock Exchange, 78% owned by BNZ.
BNZS	BNZ Services Limited, formerly BNZ Pensions Limited, a subsidiary of the BNZ.
BUDFiN	Buddie Findlay, Barristers and Solicitors.
BV	Beleggingsmaaschappij Amstelmond BV, an insurance company incorporated in The Netherlands.
CML	Capital Markets Limited, now Fay, Richwhite & Company Limited, a public company listed on the New Zealand Stock Exchange, a shareholder in BNZ from 1989 to 1992.
COOPERS	Coopers & Lybrand, Chartered Accountants.
DCF	Discounted cash flow. A mathematical technique used to put a present value on income which is expected to be earned over a number of years into the future.
DKB	Dai-ichi Kangyo Bank Limited, a Japanese bank.
EP GRQUP	Group of companies of which European Pacific Investments S.A. of Luxembourg is the immediate holding company. Qwnership not known. includes EPBC and EPUL.
E&Y	Ernst & Young, Chartered Accountants.
EPBC	European Pacific Banking Corporation Limited, a Cook islands incorporated company 49% owned by EPI until November 1989, now 100% owned by EPI.

EPI	European Pacific Investments S.A. incorporated in Luxembourg. Listed on the New Zealand Stock Exchange from 1987-1989.
EPNZ	European Pacific New Zealand Limited, a subsidiary of EPI. No longer active in New Zealand.
EPTCHK	European Pacific Trust Company (Hong Kong) Limited, a Hong Kong registered company owned by members and associates of the EPI group.
EPUL	European Pacific Underwriters Limited, a Cook Islands incorporated subsidiary of EPBC.
FRL	Fay, Richwhite & Company Limited. A New Zealand listed public company.
ICAEW	Institute of Chartered Accountants in England and Wales.
MORGANS	Morgan Guaranty Trust Company of New York, a bank incorporated in the United States of America.
NAB	National Australia Bank Limited, an Australian bank, a subsidiary of which acquired the shares of the BNZ in November 1992.
NCD	Negotiable Certificate of Deposit. A transfer,able financial instrument commonly issued by banks and other financial institutions.
NZSA	New Zealand Society of Accountants.
Operational Review Committee	A subcommittee of the Board of the BNZ chaired by Sir Michael Fay, established in November 1990 at the request of the Minister of Finance to review major aspects of the Bank's operations.
RBNZ	Reserve Bank of New Zealand.
Registrar	The Registrar of Companies.
RMcV	Russell McVeagh McKenzie earliest & Co, Barristers and Solicitors.
RWS	Rudd Watts & Stone, Barristers and Solicitors.
"the Act"	The Securities Act 1978.
"the arrangements"	The contractual and other arrangements entered into by the BNZ in March 1988 under which BNZ is indemnified by BNZS against losses up to $200 million in its loans and investments.

"the Bank"	Bank of New Zealand.
"the Capital Notes"	A US$200 million issue of perpetual subordinated capital notes made by the Bank in March 1988.
"the Crown"	The New Zealand Government.
"the first hearings"	Hearings conducted at the offices of the Commission over the period 12 Janaury to 9 February 1993.
"the second hearings_	Hearings conducted at the offices of the Commission over Thurday and Friday 22 and 23 April 1993.
Unders and Overs Schedule	A schedule prepared by an auditor which sets out and quantifies those items for which there is a difference in accounting treatment between the auditor and the company preparing the financial statements.
Zero Coupon Bond	A form of financial instrument on which no coupon interest is paid. Investors receive their return by purchasing the bond at a discount which incorporates the rate of return they will earn over the term of the bond.

ALPHABETICAL LISTING OF PERSONS REFERRED TO FREOUENTLY* IN OUR REPORT

BAYLISS, L.C.	**Board member BNZ at 30/9/87. Retired 23/7/91.**
CAMPBELL, R.C.	**Board member BNZ at 30/9/87. Resigned 14/3/89.**
CHIN, J.	**Partner, Coopers & Lybrand.**
CONGREVE, DR R.L.	Board member, BNZ 6/8/89 to 11/11/92.
CURRY, G.P.	**Barrister and Solicitor, Partner, Russell McVeagh McKenzie Bartleet & Co, representing certain former directors of the BNZ.**
DIACK, R.J.	**Chief manager, Corporate Financial Services, BNZ in 1987, now Principal, Investment Banking BNZ.**
DOWLAND, M C.	Legal counsel employed by BNZ since February 1987. Currently head of the BNZ's legal unit.
FAY, SIR MICHAEL	**Director of BNZ from 6/6/89 to 11/11/92.**
GARTY, P.A.	**Audit Partner of Ernst & Young, Chartered Accountants, responsible for audit of BNZ.**
HAYS, P.L.	**Partner of Porter Wigglesworth & Grayburn, Chartered Accountants, of Auckland.**
HICKEY, MS E M	**Partner and National Director of Accounting from 1990 for Ernst & Young.**
JONES, M	Legal counsel employed in 1987/88 by EP New Zealand Limited.
LOJKINE, OR S.M.	Director of BNZ at 30/9/87 until resignation on 23/11/89.
McCAY, R.B.	Chief Executive of BNZ at 30/9/87 until retirement in May 1989.
NANKIVELL, P.A.	Partner of BOO Hogg Young Cathie, Chartered Accountants, in 1988/89, now in private practice.
PEARSON, F.S.	Director of BNZ at 30/9/87 until retirement on 26/7/89. Chairman February/July 1989.
PHILLIPS, B.R.	Manager, Group Accounting, BNZ from January 1990 to present time.

*** More than once**

PURViS, C.P.	Chief Manager, Group Accounting, BNZ. involved with BNZ group accounting in 1988 to the present time.
PYNE, LC.	Managing Director BNZ from 115189 to 20111/92.
RATNER, P.E.	Barrister and Solicitor, Partner, Rudd Watts & Stone, representing Ernst & Young.
RiCKETTS, G.T.	Director BNZ 26/7/89 to 11111/92.
SADLER, D.G.	Director BNZ 14/3/89 to 11111/92. Chairman of Audit and accounting Subcommittee of the Board from 2/3/1990.
SHELTON, D.C.	Chief Financial Officer of BNZ from December 1989 to June 1991.
TENNENT, T.S.	Assistant General Manager BNZ in 1988, recently appointed Deputy General Manager and Executive Director, BNZ.
TRAVERS, P.R.	Chief Manager, investment Banking Group, BNZ in 1987, retired May 1989.
TROW, PROF. D.G.	Professor of Accountancy, Victoria University of Wellington.
WILSON, W.M.	Barrister and Solicitor, Partner, Bell Gully Buddie Weir, representing BNZ.

REPORT OF AN ENOUIRY UNDERTAKEN

BY THE SECURITIES COMMISSION

INTO CERTAIN ARRANGEMENTS ENTERED

INTO BY BANK OF NEW ZEALAND

IN MARCH 1988

1.0 INTRODUCTION

Background

1.1 In March 1988 Bank of New Zealand ("the Bank" or "BNZ") entered into certain arrangements through members of the European Pacific Group of companies (the "EP Group") based primarily in the Cook Islands. The arrangements were evidenced by formal agreements and by associated undertakings between the parties. These arrangements (referred to in this report as "the arrangements") purported to give a form of indemnity to the Bank against losses of up to $200 million which might arise within its portfolio of loans and advances over a period of five years. The Bank paid a single premium of approximately $110 million which was invested in securities yielding $200 million. Although the Bank could make claims at any time, it was entitled to receive payments, totalling $200 million, according to a fixed schedule over the period 1990 to 1993. The sum of $200 million represented $110 million plus notional interest over the five year period of the policy of $90 million.

1.2 The arrangements remained in place for their full term, winding up on 30 March 1993. The Bank took benefits under the arrangements into its

published financial statements for each financial year from the year ended 31 March 1989 up until 31 March 1993.

1.3 **On 15 October 1992 the Commission decided to undertake an enquiry into the arrangements. The Commission made its decision after considering allegations which had been made in the House of Representatives and repeated in the nows media concerning the alleged misuse of these arrangements by the Bank in its published financial statements. The terms of reference for the enquiry are set out in Appendix A of this report.**

1.4 The quorum of Members dealing with this manor comprised:

Mr P.D. McKenzie (Chairman)
Mr R.A. Anderson, and
Mr R.E. Baker.

1.5 **The Commission made privacy and confidentiality orders under section 19(5) of the Securities Act 1978 (-the Act") relating to the subject matter of this and related enquiries. The Commission wished to facilitate full disclosure of documents and other evidence in the shortest possible time. We believed this could best be achieved by receiving evidence privately and confidentially. The orders were modified on 8 May 1993 to facilitate the publication of this report. A copy of the present orders is attached as Appendix B. They remain in force in this form.**

Proceedings

1.6 The Commission made requests in October 1992 to BNZ and to the two firms of auditors who had acted for the Bank in the period covered by the enquiry, Ernst and Young (.E & Y") (formerly Ernst and Whinney), who acted throughout the period and BOO Hogg Young Cathie ("BDO`), who ceased to act in June 1989, for all books and papers in their possession or control

relative to the arrangements. The Governor of the Reserve Bank of New Zealand was also asked at that time for comment.

1.7 The Bank and E & Y separately provided a significant volume of material to us in mid-November. BDO advised that it had no relevant documents in its possession.

1.8 Following initial analysis of the material received we asked the Registrar of Companies (`the Registrar-) for certain information relating to registration of one of the Bank's debt security prospectuses. We also summoned the accounting firm of Coopers & Lybrand (`Coopers') to produce information relating to an assignment it had carried out for the Bank in 1990/91.

1.9 To ensure that we had received all relevant information relative to the enquiry we summoned BNZ and E & Y on 8 December 1992 to produce any further books and papers in their possession or control. The summons extended to the legal advice given to the Bank by its legal advisers, Buddie Findlay ('Budfin`) and to all advice received by the Bank's Board of directors relating to the Bank's levels of doubtful debt provisioning from the year ended 31 March 1988 to the year ended 31 March 1991. We also summoned BOO to produce any documents in its possession or control.

1.10 The Bank provided material to us on 23 December 1992 and an affidavit as to documents of the Bank's chief executive officer, Mr R.M.C. Prowse. By agreement certain customer confidential information was made available for inspection by Commission staff at the Bank's premises. The Bank claimed legal privilege in respect of legal advice received by it and, after discussion, the Commission decided not to contest this claim.

1.11 E & Y provided information to us under cover of a loner of 15 December 1992 and by agreement made available for inspection by Commission staff at its premises all its audit work papers relating to the Bank's doubtful debt

provisioning from the year ended 31 March 1988 to the year ended 31 March 1991.

1.12 On 23 December 1992 we issued to the Bank and certain other parties a summary review of the written material we had received to the end of November 1992.

1.13 We conducted hearings ("the first hearings`) over 10 days from 12 January to 9 February 1993 during which we received evidence from 26 persons, including present and former directors and executives of the Bank, present and former partners of the Bank's two auditing firms, partners of Coopers, staff of the Registrar and two expert witnesses. We also received preliminary submissions on behalf of the Bank.

1.14 We consulted a number of persons in regulatory agencies, professional bodies and financial institutions, both in New Zealand and overseas, in order to gain an understanding of the use of, and manner of accounting for, arrangements of the kind entered into by the Bank. Those consulted include officials of the Accounting Standards Board of the United Kingdom, the Institute of Chartered Accountants in England and Wales, the United Kingdom Department of Trade and Industry and the Financial Accounting and Standards Board of the United States of America. We obtained a number of papers from these sources and have drawn from this material where appropriate.

1.15 We surveyed banks operating in New Zealand to determine the prevalence of the use by banks in New Zealand and, through the Head Offices of those banks, overseas, of socalled 'captive- insurance arrangements covering banks' potential bad debt losses. The results of the survey are set out later in the report at section 5.

1.16 On 12 March 1993 we issued to the Bank and certain other persons a confidential consultative draft report of the Commission. The purpose of this draft report was to record the preliminary views of the Commission on the evidence received to that time. The distribution of the draft report was extended to all persons who in the view of the Commission in the terms of the draft report might be perceived to be the subject of Commission comment whether adverse or otherwise. We wished to ensure that those who received the draft report had the opportunity to consider the comments carefully and, if they wished to, to make submissions whether in writing or orally.

1.17 We requested that all written submissions be in the hands of the Commission by no later than 5 p.m. on Friday 26 March 1993. We received a number of very pressing requests for extension of this deadline and certain extensions were agreed to. Most written submissions were received at the offices of the Commission by Monday morning 19 April 1993. Several persons requested the opportunity to present oral submissions and, in some cases, further evidence.

1.18 We conducted hearings (.the second hearings.) on 22 and 23 April for the purpose of receiving the oral submissions and further evidence.

1.19 All evidence in the enquiry was received on oath. The hearings were tape recorded and transcribed. The transcript exceeds 2000 pages. The transcript of the first hearings was available to counsel in advance of the second hearings. There were also several thousand pages of documentary evidence. A full list of those appearing before us is set out in Appendix C.

1.20 Counsel who made submissions to or appeared before us, and the parties they represent, were:

Bell Gully Buddle 'Weir, Wellington representing Bank of New Zealand

Mr W.M. Wilson

Mr G.J. H. Sharp

Mr M.G. Colson

Rudd Wans and Stone, Wellington representing Ernst and Young

Mr P.E. Rainer

Mr F.J. Handy

Russell McVeagh McKenzie Bart|eat & Co, Auckland representing Sir Michael Fay, Messrs LC. Pyne, D.G. Sadler, S.D. Pasley, Dr R.L. Congreve and Mr G.T. Ricketts (former directors of the Bank):

Mr G.P. Curry

Mr K.J. Catran

Mr A.M. Peterson

Chapman Tripp Sheffield Young, Wellington representing Coopers & Lybrand:

Mr B.J. Brown

Chapman Tripp Sheffield Young, Wellington representlng Mr T.K. McDonald (current director of the Bank):

Mr S.L. Franks

Phillips Fox, Welllngton representing Mr P.R. Travers (former executive of the Bank):

Mr R.J.B. Fowler

1.21 **In the course of the second hearings the Commission received certain submissions on the procedures adopted by the Commission for the enquiry and the Commission's jurisdiction. We review these submissions and the Commission's opinion on them is set out in Appendix D.**

1.22 **Shortly after we commenced our enquiry we received a letter dated 26 November 1992 from Mr W.R. Peters, M.P. containing further allegations relating to the arrangements whlch had been entered into by the Bank. That !suer was carefully considered. The Chief Executive of the Commission** informed Peters on 1 March 1993 that the Commission would receive any further material or submissions but in subsequent correspondence Peters has querled the timing of this. The Commission made its position clear in subsequent correspondence in late April 1993.

European Pacific Group of Companies_

1.23 **In November 1992 we requested informatlon from the EP Group of companies. BGBW Auckland informed us, by !suer dated 7 December 1992, on behalf of the EP Group that:**

> ***...the Cook Islands has extensive legislation protecting the conf/dentiallty of information concerned or connected with Banking and other financial transactions. Indeed this legislation prohibits the disclosure of such information. It also prov/dos for various offences by Banking and other financial institutions and/or their officers who may act in breach of the legislation. These offences relate not only to acts within the Cook Islands but also have extra territorial application.***
>
> ***In all the circumstances European Pacific Is simply not In a position to be able to agree to provide the information that you have sought.***

1.24 BGBW Auckland thereafter claimed that this was so notwithstanding that BNZ had consented in writing to the release of documents material to its affairs and that privacy and confidentiality orders applied in respect of the Commission's proceedings.

1.25 We do not accept this claim. We wrote to BGBW Auckland on three occasions asking them to cite the authority on which they asserted that the EP companies would be in breach of law in tendering documents in response to the Commission's request. BGBW Auckland did not

acknowledge our letters.

1.26 This is an unsatisfactory situation. In our view it does not reflect well on a company that it has carried on significant business in New Zealand but will not co-operate with the regulatory authorities in this country.

1.27 We obtained various internal EP Group loners and documents from sources other than the group itself. Our report includes a number of references to those letters and documents.

.General

1.28 Our enquiry was commenced while the management of the Bank was under particular pressure as a result of the takeover offer by a company of the National Australia Bank Limited group. We appreciate and are grateful for the effort made by the Bank in meeting our requests for information and documents. This often required the searching of many files going back over a number of years.

1.29 Where individual persons are referred to in this report we use the customary

1.30 We have divided our report into six parts

Part I deals with the establishment of the arrangements; discusses the nature of the arrangements and the resultant funds flows; examines the question of whether the arrangements are a genuine insurance transaction at law; reviews the procedures by which the arrangements were put in place, including the reasons why the Bank entered into them; and looks at captive debt insurance by banks.

Part 1I deals with issues arising from our consideration of the Bank's March 1988 financial statements including the allegations made by Peters; reviews those financial statements; and sets out the Commission's findings on the manor.

Part III examines the legal responsibilities of directors and auditors with respect to published financial statements; discusses the appropriate accounting treatment for such arrangements and provides the Commission's views on this issue; and provides an overview of how the Bank has used and accounted for the arrangements over the period of their existence;

Part IV separately considers each of the Bank's published financial statements since September 1988; expresses the Commission's view of the influence the arrangements may have had on the truth and fairness of those financial statements; separately reviews all the Bank's debt security prospectuses since June 1988 and expresses our view on compliance with the provisions of the Securities Regulations 1983.

Part V deals with various miscellaneous matters on which we consider it is appropriate to comment, including: whether we have found any evidence of fraud by any person, breach of fiduciary duty by any director, or Improper influence on the Bank's affairs by any major shareholder; some particular aspects of the Bank's administration of the ,arrangements; and the Bank's reporting to the Reserve Bank of New Zealand.

Part VI contains our conclusions and sets out the bodies to whom we are referring our report.

PART I

ESTABLISHMENT OF THE ARRANGEMENTS

2.0 BACKGROUND

2.1 **At the beginning of 1987 the Bank was New Zealand's largest trading Bank, holding approximately 40% of the total deposits of the Banking system. It was wholly owned by the New Zealand Government ('the Crown").**

2.2 On 12 February 1987 the Bank offered 103 million non-voting 50 cent shares for public subscription at a price of $1.75 per share, raising new capital of $180.25 million. Following the share issue the Crown held 87.1010 of the issued capital of the Bank.

2.3 The Bank was expanding rapidly. On the basis of the Bank's published financial statements its total assets grew by 20.4010, from $14.6 billion to $17.6 billion, in the year ended 31 March 1988.

2.4 **For the first nine months of 1987 the New Zealand economy was relatively buoyant, particularly in the property and investment areas. The Bank actively participated in these areas of buoyancy. In October 1987 the world-wide sharemarket crash took place.**

2.5 **The Bank's directors and management have said in evidence that they were conscious that the world-wide share market crash had the potential for both direct and indirect effects on the Bank. The Bank had advanced funds to a number of parties directly or indirectly on the security of shares. It was also exposed to the property sector. The directors and management did not know at that time whether the sharemarket collapse would be short-lived or**

prolonged. They did not know whether or to what extent there would be a flow through to the property market.

2.8 **Bank witnesses gave evidence that by the end of 1987 they were becoming concerned about the long-term impact of the sharemarket collapse on the Bank's exposures, particularly its corporate and property exposures. Many of these exposures had originated in the Investment Banking Group, of which Mr P.R. Travers was at the time General Manager.**

2.7 **In late 1987 Travers instructed Mr R.J. Diack, then Chief Manager, Corporate Financial Services, to undertake a number of special reviews of the Bank's larger corporate exposures. Diack was responsible for improving the Bank's security position on those corporate exposures where the Bank's position was considered to be relatively weak.**

2.8 During early 1988 Diack received an approach from Mr M Jones of the EP group with a proposal for a type of insurance arrangement which would provide cover against a specified risk of loss in the Bank's loan portfolio. The first record of this approach is a loner dated 24 February 1988 from Jones to Diack and Mr M C. Dowland, then Corporate Legal Counsel, of the **BNZ. It was acknowledged that that letter would have been preceded by meetings and/or conversations between the parties.**

The approval process

2.9 **The directors of the Bank first received notice of the proposal for the Bank to enter into the arrangements at their meeting on 17 March 1988. This was conveyed in a memorandum of 15 March 1988 signed by McCay as Group Chief Executive but prepared for him by Diack. The text of the memorandum was:**

INSURANCE COVER

CREDIT AND INVESTMENT RISK

1. ***We are !acing certain situations where potentially a loss could occur at some forward time, but with the possibility of loss uncertain as to event &mount and time.***

2. ***Whoa not warranting a specific provision now, recognising the imponderables involved, it would nevertheless be prudent for us to insure against a loss or losses eventuating to protect the performance of the Bank until such uncertainties are removed.***

Examples are.' -

The Bank's equity and 5 year loan facility relating to the Ariadne shares

The unsettled balance of forex transactions as referred,
Agenda Paper No. 883/8.8

Exposures to the property market In the event this deten.orates or collapses

Similarly exposures related to the share market should another "19 October" occur.

4. ***We are therefore examining the viability of establishing a captive based insurance cover, up to $200 million, for an ensuing 5 year period; effectively enabling any losses resulting from situations positioned under this cover to be directly recovered against the sum insured.***

Terms of the cover can, within reason, be sufficiently flexible to meet any situations envisaged.

5. ***The benefit of establishing insurance cover is to avoid the impact on profit of a large write-off In any one year by spreading the risk more evenly through the payment of an annual premium. Effective cost of the programme and[sic] the 5 year period is similar to writing off the same amount of debt but smooths the***

6. ***Existence of appropriate insurance cover willprovlde the auditors with a degree of assurance when testing the adequacy of doubtful***

debt management. The policy may also provide comfort to rating agencies when assessing the Bank's credit standing.

7. ***Both Ernst & Whinney and Buddie Findlay, with whom we have extensively discussed the concept and practical application, fully endorse the validity and the viability of the approach for the purposes intended. Both parties will be directly involved in fl.nail.sing arrangements and documentation, for their final certificates.***

RecOmmendatiOn

8. ***WhHe it has not been possible to complete details for this Board Meeting, there are obvious benefits in putting the insurance cover in place and enacting the premium before 3lst March.***

9. ***Accordingly, to enable this to be achieved, I recommend that the Board authorise a sub-committee of Mr Campbell and one of Mr Bayliss or Mr Pearson to consider and approve as appropriate final submission and recommendations for the establishment of insurance cover as outlined and the associated premium payment.***

R.B. McCay (signed)
Group Chief Executive

2.10 The directors present at the meeting which considered this memorandum were: Mr R.J. Campbell, Deputy Chairman, Messrs P.G. Morrison, LC. Bayliss, F.S. Pearson, P.W. Learning and Dr S.M. Lojkine. Sir Ronald Brierley, Chairman of the Bank at the time, was not present.

2.11 The memorandum, although referring to the level of coverage of the arrangement, and mentioning "captive based" insurance cover, included very few of the relevant details. it referred to "extensive discussions" having taken place with the Bank's auditors and legal advisers.

2.12 The Bank's directors would have had the opportunity to read the paper the day before the Board meeting. It was customary for directors to visit the Bank that day and read the Board papers in a room specially set aside for

their use. informal discussions would often take place among directors in that forum.

2.13 The directors who were involved in that Board meeting and who gave evidence before us can not recollect significant discussions prior to the Board meeting. They can recall the manor as coming late in the agenda. Some directors recall that they had insufficient information and insufficient time to consider the proposal. Lojkine told us at p.942:

> ***The first impression that I would /Ike to convey to you Is that I felt the Board were rather railroaded into this arrangement because It only came up at the last minute In the financial year. Management seemed to be on top of It and they were keen to do It ...***

Campbell said at p.792:

> ***I think that the consensus view of the Board on reading the paper was that the Board was really at best lukewarm about the proposal and felt that the 15 March paper provided insufficient detail about how it might work and what /ts Implications were ...***

Pearson told us at p.1142:

> ***I just remember my reaction at feeling hijacked by this proposal of you know a complicated thing of this nature which I didn't understand at the /ate stage ...***

and at p.1147:

> ***../ remember resenting being asked to take something seriously of such complexity at short notice ...***

2.14 In view of the shortness of time available before balance date on 31 March 1988 management had recommended that the matter be referred to e subcommittee to enable consideration to be given to the proposal before the end of the month. Directors may have been comforted by the referral of the **proposal to the subcommittee.**

2.18 **The Board sub-committee comprised Campbell and Bayliss. It met in late morning on 30 March 1988, with several senior management personnel present, and formally approved the Bank entering into the arrangements. The sub-committee was provided with a memorandum dated 30 March 1988 signed by McCay, the text of which reads:**

INVESTMENT AND CREDIT RISK INSURANCE POLICY

1. ***At the last meeting of the Board Agenda Paper No 883/8/9, ..., introduced the concept of the Bank insuring certain risks, which were exampled.***

2. *The Board accepted the recommendations that to enable such an Insurance Policy to be put in place by 31 March 1988 a sub-committee would consider and approve an appropriate final submission and recommendation for establishment of insurance cover as outlined and the associated premium payment.*

3. ***An Insurance Policy has been negotiated to satisfy our requirements as established In the earlier Agenda Paper.***

Details of the Policy are.'

a)Insured Group: Bank of New Zealand Group

b)Indemnifier: BNZ Pensions Ltd (NZ Registered)

c) ***Risks indemnified: The Bank .is indemnified against any loss it may incur in respect of its failure to collect certain debts and any loss made from certain investments. The definition of debts and investments is wide enough as to cover any known amounts due to the Bank from loans of any kind or prospective losses including those relating to the unsettled balance of forex transactions, referred to [elsewhere]***

d)Maximum amount claimable_ NZ$200 M

e) Period of Indemnity: S years renewable annually thereafter for a premium to be agreed.

f) Claims.' The policy has been designed to require the claim
to be met where the Bank's loss is certified by one of the

g) *Premium.' The premium will be paid as a single payment made on the signing of the policy. Fina/ negotiations as to amount are being concluded presently. The maximum premium will be $110 million which will be &mortised over 5 years at approximately $22 M per annum.*

h) *Payment: The policy is structured so that while claims may be made by the Bank and accepted by the indemnifier nevertheless the maximum amount payable in the first four years of the policy is restricted to $10 M per annum in years 2, 3 and 4. The balance of $170 M is payable in year 5.*

4. *The policy is based on captive insurance principles and the indemnifier (BNZ Pensions Ltd) has insured its total responsibilities under the policy through the Netherlands broker Kamerbeek Assurantiemarke/aas BVto a Company wholly owned by Kreditbank: Be/eggingsmaaSchappij Amstelmond BV.*

S. *The single premium is invested in Zero Coupon Bonds issued by prime institutions. The Bonds will mature as follows $10 M per annum in year 2, 3 and 4 and $170 M in year S. The Bonds are held in trust for the benefit of the policyholder.*

6. *The indemnity arrangement proposal provides the benefit of avoiding the impact on profit of a large write-off in any one year by spreading the n.sk through the &mortising of the premium over a 5 year term.*

7. *Our solicitors and auditors have been closely involved in the development of the insurance policy and appropriate legal and audit opinions are being provided.*

Recommendations

I am satisfied with the objectives and form of the arrangement and recommend the establishment of an insurance policy of $200 M and payment of the premium.

R.B. McCay (signed)
GROUP CHIEF EXECUTIVE

2.16 The sub-committee could not have had long to consider the memorandum, since it was dated 30 March 1988 and the meeting took place late morning

not record the directors who were present.

The parties Involved

2.22 Our understanding is that the major parties to the arrangements were

(a) **BNZ Services Limited ("BNZS"), formerly BNZ Pensions Limited, is a wholly owned subsidiary of the Bank of New Zealand with a paid-up share capital of $10,000. We have been told that BNZS was a "shelf" company prior to its use in this transaction and has no connection with any pension services provided by the Bank for its own staff or externally;**

(b) **BeleqqinqsmaaSchappij Amstelmond BV ("BV") is a Netherlands registered insurance company that is notionally owned by Kredietbank SA of Luxembourg, itself an associate of the major Belgian Bank Kredietbank NV. BV appears to have a capital of 100,000 Dutch guilders, approximately NZ$90,000. Kredietbank SA had total assets of US$13.0 billion at 31 March 1991;**

(c) European Pacific investments S.A. ("EPI"), which is incorporated in Luxembourg and is the parent of the EP Group. At the time the Bank entered into the arrangements EPI was listed on the New Zealand Stock Exchange and had a paid up capital of $US5O million. EPI's share capital was owned as to 28'Io each by the BNZ, Capital Markets Limited (-CML") and Brierloy investments Limited ("BIL"). 100/o of the shares were held by a Mr David Lloyd, and the balance by the Now Zealand public.

EPI was listed on the New Zealand Stock Exchange on 5 January 1987 and donated on 20 November 1989 at the company's request following an Extraordinary General Meeting which

approved a capital reduction of **98010. Travers was a member Of the Board Of EPI** for **much Of this period. Diack was his alternate on the Board.**

According to a .Memorandum to Shareholders` of EPI, dated 31 October 1989 and signed by Mr D.M. Richwhite as Chairman, the BNZ and CML sold their respective shareholdings around that time to Laverton Securities Limited, a company associated with the management of the European Trust and Banking Group Limited.

We are unaware of the current ownership of EPI;

(d) European Pacific Banking Corporation ("EPBC") is a Cook Islands registered Banking subsidiary of EPI. Its capitalisation is not known. At the time the arrangements were entered into EPI held 49% of the shares of EPBC, but as part of the 1989 reconstruction of EPI it was indicated that EPBC would become **wholly owned by EPI;**

(e) **European Pacific Underwriters Limited ("EPUL") is a Cook Islands registered subsidiary of EPBC. Details of EPUL's capitalisation are not known but it is expected to be modest;**

(f) European Pacific .Trust Company (Hong Kong) Limited ("EPTCHK") is a Hong Kong registered company with a share capital at 1 April 1987 of HK$1,000,000 (approximately NZ$2S0,000) with shareholders all being members or associates of the EP Group. We understand that the EP group recently sold its trust account business, but not EPTCHK, to the Standard Chartered Banking group;

Cg) <u>BNZ Finance Limited</u> **("BNZF"), is a listed public company and registered Bank 78% owned by the BNZ. Shareholders' funds at 31 March 1992 were $163 million;**

Ch) <u>Morgan Guaranty Trust Company of New York</u> **(`Morgans")** Is a **United States Bank with consolidated assets at 31 December 1988 (the latest figures available in *The Bankers' Almanac)* of $US86.8 billion;**

Ci <u>Dal-ichi Kangyo Bank Limited</u> **("DKB") is one of the three largest Banks in the world with total assets at 31 March 1991 of $US457** billion and a December 1992 Moodys rating of AA3 for its long-term obligations.

The formal contractual documents

2.23 The formal legal documents relating to the establishment of the arrangements were as follows:

Ca) BNZ entered into a <u>Deed of Indemnity</u> on 30 March 1988 with BNZS under which BNZS indemnified BNZ against losses of up to $200 million on specified lending and investment risks (as defined) up to a maximum face value of $2 billion. The cost of this indemnity was $109,812,209.90 including premium, fees and expenses (see Appendix E);

Cb) BNZS entered into an <u>Investment and Credit Risk Insurance Contract</u> with BV dated 30 March 1988 which provides ,BNZS with back-to-back cover for its obligations under its Deed of indemnity with BNZ. The directors of BNZ Pensions Limited resolved on 30 **March 1988 to enter into the insurance arrangements. The cost of the premium was $108,560,977.09 (see Appendix F);**

Cc) BV entered into a Reinsurance Contract with EPUL on 30 March 1988 for 90% of the amount of risk insured between BV and **BNZS. BV retained 10% of the risk. The cost of this reinsurance was $97,704,879.00 (see Appendix G);**

Cd) **EPUL and BV entered into separate Deeds of Trust with EPTCHK on 30 March 1988 whereby the trustee (EPTCHK) agreed to hold on trust for the insured party (BNZS) all relevant securities placed with it by EPUL or BV respectively. Under the terms of the Deed of Trust the first** call **on the proceeds on the maturity of the securities was to meet the costs, charges, expenses and liabilities of the trustee and the second priority was to pay the claims of the insured parties under the insurance policy (see Appendices H and I).**

The funds flows

2.24 The principal funds flows involved in the arrangements at the time they were first set up included:

Ca) On 31 March 1988 BNZ paid to the credit of EPBC $109,812,209.90, of which $108,560,977.09, the premium payable under the arrangements, was credited to an account at EPBC in the name of BV while the balance, $1,251.232.81, the cost of various fees and expenses, was credited to a European Pacific group company account at EPBC. BV then paid $97,704,879.00 to EPUL's account at EPBC. BV and EPUL deposited $10,858,097.00 and $97,704,879.00 respectively in an account in the name of EPTCHK at EPBC. EPTCHK then **deposited these funds into an account at the BNZ Singapore where they remained on deposit until 6 April 1988 (i.e., over Easter).**

(b) **On 6 April 1988 EPTCHK used $108,560,977.09 to purchase zero coupon bonds from BNZ Singapore. These bonds had a redemption value of $200 million. A letter of 11 April 1988 from BNZ Wellington to EPTCHK indicates that EPTCHK received interest of $321,855.07 on its deposit over the Easter weekend, paid $496,855.04 to BNZ Singapore by way of .interest Compensation Movemenf`, leaving a balance on the original amount paid by BNZ of $1,076,232.84 which was credited to EPBC's account with the BNZ Wellington.**

(c) On 7 April 1986 BNZ Singapore acquired Negotiable Certificates of Deposit (`NCD's') issued by BNZ's subsidiary BNZF in Wellington, for $108,834,616.22. The proceeds of the sale of these NCO's were used by BNZF to purchase identical NCO's issued by the BNZ Wellington.

2.25 The terms of issue of the Certificates of Deposit and Bonds were:

Issue Date	Maturity Date	Face Value	issue Price	Yield o/_2
7.4.88	30.3.90	$10 mn	$7,580,531.01	.14.50
7.4.88	29.3.91	$10 mn	6,684,989.46	14.00
7.4.88	31.3.92	$10 mn	5,889,302.49	13.75
7.4.88	31.3.93	$170 mn	88/679/793.24	13.50

The $200 million face value of the bonds represents the total amount of the indemnity under the insurance arrangements.

2.26 The purpose of the particular structure to the transactions described in paragraph 2.24 was explained in a memorandum from Diack to McCay of 27 April, 1988:

The above structure is required to avoid GST on the premium, under the Double Tax Agreement between New Zealand and Holland, to ensure deductibility of the premium and to mlnimise the risk of being liable to New Zealand Withholding Tax.

2.27 The proceeds of the premium did not remain invested in NCO's issued by BNZ and BNZF.

On 9 August 1988 BNZ repurchased its NCO's from BNZF for $113,455,000.00. BNZF redeemed its NCO's then on issue to EPTCHK on the same day for the same amount.

(a)

BNZ Singapore, in a memorandum dated 5 August 1988, instructed BNZ Wellington to pay the proceeds of this redemption to an account at BNZ Wellington in the name of EPUL. By a memorandum of 8 August 1988 EPBC instructed BNZ Wellington to pay these funds to the account of Morgans (London Branch) at BNZ Wellington..

(c) On 25 August 1988 EPTCHK made a deposit of $113,454,600.00 with DKB, evidenced by a Deposit Agreement dated 25 August 1988 (see Appendix J).

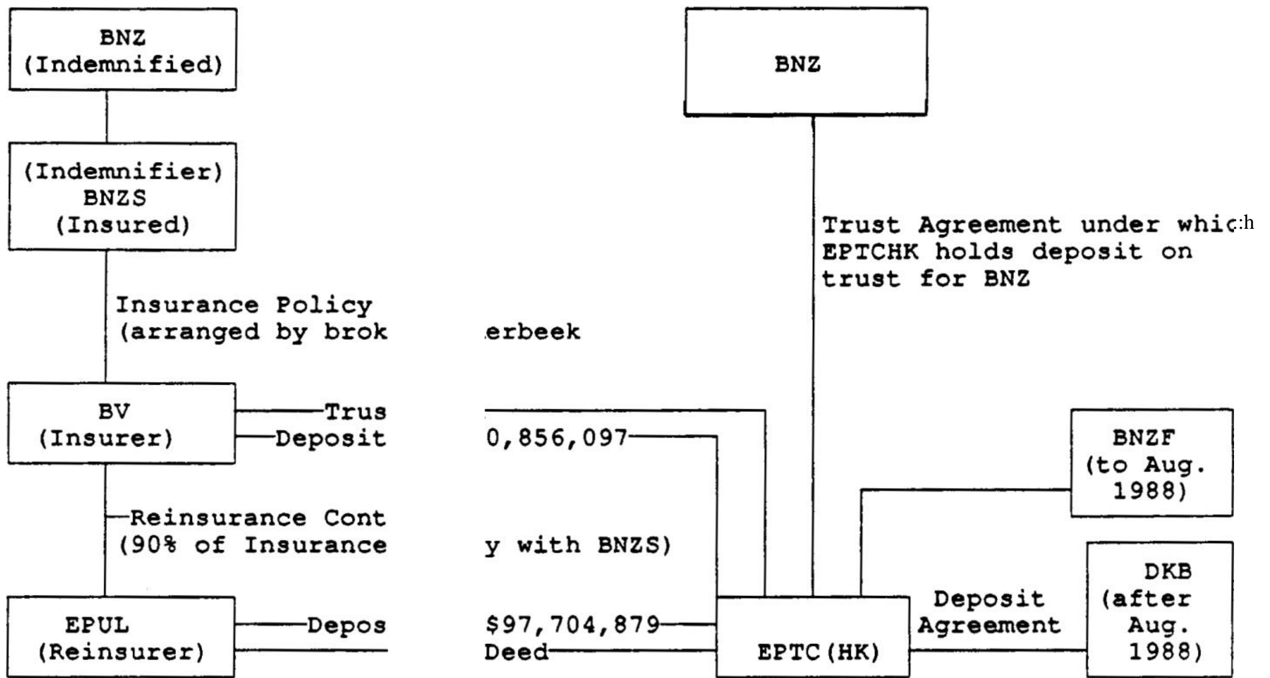
The deposit had coupon payments of:

31 March 1990	$10,000,000
31 March 1991	$10,000,000
31 March 1992	$10,000,000

and a final maturity of:

31 March 1993	$170/OOOzOOO

2.28 A diagram saning out the above relationships is set out below:



All transactions took place on 31 March 1988 except the investment with BNZF which occurred on 6 April 1988 and the deposit agreement with DKB which occurred on 25 August 1988.

2.29 The arrangements terminated on 31 March 1993 when the proceeds of the maturity of the DKB deposit were received by the Bank.

3.0 ARE THE ARRANGEMENTS A GENUINE INSURANCE TRANSACTION AT LAW?

3.1 **As we shall see later the question whether or not the arrangements are a genuine insurance transaction has some significance when considering how the use of the arrangements should have been treated in the financial statements of the Bank. The legal form is not, however, determinative on the question, and if the arrangements, although in legal form an insurance contract are in substance a form of investment, then the substance of the arrangements would have to be recognised when accounting for them.**

Do the Insurance Contracts reflect the true agreement between the Denies?

3.2 Diack has told the Commission that he instructed the Bank's solicitors, Budfin, to draw up the documents as an insurance contract.

3.3 **The Bank has informed the Commission that it does not have any written legal advice on the question of the effectiveness of the arrangements as an insurance contract, although it did receive legal advice from Budfin on taxation questions which were not material to the Commission's enquiry.**

3.4 In submissions during the course of the enquiry, BGBW argued for the Bank that the insurance documents were not in law a sham because they were "legally enforceable and at all times accurately reflected the agreement between the parties`. They referred to comments by Mr Justice Richardson in NZI Bank Limited v Euro National Corporation Limited {1992} 3 NZLR 528, 539:

> *The legal principles are we// sen/ed. First the true nature of the transact/on can only be ascertained by careful consideration of the legal arrangements actually entered Into and carried out. It Is not to be determined by an assessment of the broad substance of the transact/on measured by the overall economic consequences to the participants. The forms adopted cannot be dismissed as mere machinery for effecting other purposes. At common /aw there is no half-way house between `sham and character/sat/on of the transact/on according to the true nature of the legal arrangements entered Into and carried out. A document may be brushed aside If and to me extent that It Is a sham In two situations. The first is where the document does not reflect the two agreement between the pad/es In which case the cloak is removed and recognition is given of their common Intentions. The second is where the document was bona fl'do In Inception but the pad/es have departed from their initial agreement while leaving the original documentation to stand unaltered. Once It Is established that a transact/on Is not a sham /ts legal enact will be respected.*

It is important to bear in mind, however, that the refusal by the common law to recognise any "middle-slot" or half-way house between a sham and the character|sing of a transaction according to its legal form, means that the courts will give effect to a transaction in accordance with its expressed legal form where the true intent of the parties requires this, notwithstanding that this form may differ from the "substance" of the transaction viewed in relation to its economic purpose and effect: Re Securitibank Ltd {No. 2) [1978] 2 NZLR 136, 150-152, 164-165, C.A. The distinction between legal form and the substance of a transaction was clearly expressed by Richardson J. in Marac Life Assurance Ltd v C.I.R. [1986] 1 NZLR 694, 706:

> *The true nature of a transaction can only be ascertained by careful consideration of the legal arrangements actually entered into and carried out; not on an assessment of the broad substance of the transaction measured by the results intended and achieved or of the overall economic consequences.*

3.5 The Bank's directors and executives acknowledge that there was no potential for any cash or other economic benefits accruing to the Bank from the policy

because the Bank would only get back its original "depOSit" with interest. Regardless Of the form Of the arrangements, they were designed primarily tO allow the Bank to smooth its reported profits. The premiums were to be written Off over the life Of the policy. Clack said that the potential fOr income smoothing was the main justification for the arrangements and that this had been made clear to the directors.

3.6 This view was shared by the EP Group, through which the arrangements were put together. In a memorandum dated 31 March 1988 from Mark Jones to the directors of EPBC, under the heading "Description of Transaction", the following explanation is provided:

> 17.1 *The insurance transaction is designed to enhance a financial Institution's balance sheet. Instead of making an immediate provision in the institution's accounts for the debts the premiums are written off over the life of the policy.*
>
> 17.2 *The insurance policy that is being taken out will ensure that the BNZ Group need not show the total extent of the write-off of doubtful debts in their accounts in the present financial year and thus affect their financial position. If $200 million was written off immediately this would have a detrimental enact on BNZ's Sean.ng ratios. Rather BNZ will accrue the premium and show it as a deduction across the five year life of the policy. This is a profit smoothing technique.*

3.7 The premium (approximately $IIOM) paid by the Bank for the indemnity was initially invested in zero coupon bonds issued by BNZ Singapore and was later invested in a deposit with DKB. This deposit had three coupon payments which have already been paid in the sum of NZ$10 million each on 31 March 1990, 1991 and 1992. The final maturity for NZ$170 million took place on 31 March 1993 and has been the subject of claim by the Bank. The premium was therefore used solely as a financial investment for the benefit of the Bank.

3.8 The bond/deposit arrangements were not recorded in the formal legal documents. A memorandum prepared by Mark Jones at the time the documents were finalised expressly set out the initial bond arrangements. By

memorandum dated 29 March 1988 sent to Clack and Dowland, Jones records the maturity dates and respective amounts of the four bonds. Later in the same memorandum Jones records that:

> *4.5* ***On the 3lst of March 1990 BNZ can make a claim for up to NZDIO million under the policy.***
>
> *4.6* *On the 3lst of March 1991 BNZ can make a claim for up to NZD2O million.*
>
> ***On the 3lst of March 1992 BNZ can make a claim for NZDD3O million.***
>
> *4.7* ***On the 3lst of March 1993 BNZ can make a claim for a further NZD17O million as the final insurance proceeds***

3.9 These financial arrangements are confirmed in a memorandum dated 30 March 1988 from McCay to a sub-committee of the BNZ Board, and in the memorandum dated 31 March 1988 from Jones to the directors of EPBC.

3.10 **It is curious that the Deed of Indemnity and other formal insurance documents omitted the detail regarding the initial bond investment and the important function it served** in **the overall transaction. The central function of the** initial **bond investment was clearly set out** in **the various memoranda which were prepared at the time to explain the arrangements to both the Bank board and the EPBC board. This raises serious doubts as to whether the formal documents evidenced the entire agreement between the parties. This issue** is **discussed further in paras 3.34 to 3.43.**

3.11 BV and EPUL respectively as insurer and reinsurer under the arrangements entered into Deeds of Trust with EPTCHK whereby the trustee agreed to hold on trust for the insured party as set out in the ,Deeds all relevant securities placed with it by BV or EPUL respectively. Clause 2.6 of the Deed of Trust which EPUL had with EPTCHK provided:

> ***At the expiry of the Policy or Policies (including any renewal or extension thereof) the Securities or the proceeds thereof or the balance of such securities or such proceeds shall, after satisfaction of all outstanding liabilities under such Policy or Policies be paid to and beneficially retained by EPUL free from the trusts hereby constituted.***

It should be noticed, however, that clause 2.6 of the trust agreement between BABY and EPTCHK is in quite different terms and directs EPTOHK to hold any surplus in trust for the insured. That clause states:

> ***The expiry of the Policy or Policies (including any renewal or extension thereof) the Secun.ties or the proceeds thereof or the balance of such Securities or such proceeds shall, after satisfaction of all outstanding liabilities under such Policy of Policies, be paid to and beneficially retained by the Insured free from the trusts hereby constructed.***

3.12 **RMcV argued that the words 'the Insured- in the Deed of Trust with BV were an error and the intention of the parties was that the Deed should be in the same form as the Deed of Trust with EPUL. Oounsel drew attention to two other occasions when the word 'insured- is wongly referred to in the BV Deed and it is apparent that the reference should in each case have been to BV. The error may be explicable on the basis that BV was the .insured' under its reinsurance contract with EPUL.**

3.13 **Even accepting that the BV Deed of Trust wrongly refers to the insured and is capable of rectification, it is important to observe that the Deed of Trust in that form appears to contradict the representation made to the board of the Bank in McOay's memorandum of 30 March 1988 which in saning out what were described as being -details of the policy- states with reference to any trust on**

3.14 **The Board clearly proceeded thereafter on the basis that the arrangements created a trust over the bonds for the benefit of the Bank. In a memorandum from Mr.B.A. Stockwell (then Senior Manager, Capital Markets, Investment Banking Group) to the General Manager, Investment Banking and the Senior Chief Manager, Corporate & Financial Services dated 2 May 1969, it was stated with reference to the deposit under the arrangements with BV and EPUL:**

> ***This deposit Is held by European Trust Company (Hong Kong) Limited on trust for BNZ (the insured parfy).***

3.15 **This is another respect in which the formal documents did not evidence the entire agreement between the parties.**

Are the arrangements a contract of insurance at law?

3.16 BGBW has referred to Hardy Ivamy's text General Principle's of Insurance Law (5th ed. 1966), which provides the following generally accepted definition of an insurance contract (pages 3 4):

> ***A contract of insurance in the wider sense of the term may be defined as a contract whereby one person, called the 'Insurer', undertakes, in return for the agreed consideration, called the _Premium', to pay to another person, called the 'Assured', a sum of money, or its equivalent, on the happening of a specified event.***
>
> *The specified event must have some element Of uncertainty about ,.ti' the uncertainty may be either (a) as in the case of life insurance, in the fact that, although the event is bound to happen in the ordinary course of nature, the time Of its happening is uncertain,' or(b) in the fact that the happening of the event depends upon accidental causes, and the event, therefore, may never happen at all. In the latter case, the event is called an 'accident'.*
>
> ***The specified event must further be of a character more or less adverse to the interest Of the assured, or in other words the accident must be calculated, If it happens, to result in loss to the assured.***

> ***Where the payment of the money or other benefit is discretionary and not obligatory, the contract is not one of insurance.*** **[Emphasis added].**

As pointed out by Mr G.P. Curry of RMcV in his submissions these principles are in large part based on the leading case of Prudential Insurance Co v !RC [1904] 2 KB 658.

3.17 **A further significant feature of insurance contracts is that they are aleatory contracts, having an element of speculation. Colinvaux's Law of Insurance 6th ed 1990 summarises this principle as follows:**

> ***Contracts of Insurance, like wagering contracts are aleatory contracts" depending on an uncertain event of contingency as to both profit and loss (Webster's New International Dictionary (2nd ed)),- for financial or other consideration the insurer agrees to pay or otherwise benefit the assured on the happening of a specified event or contingency which is outside the control of the insurer. "Insurance is a contract upon a speculation" (per Lord Mansfield in Garter v Boehm (1766 3 Burr. 1905)).***

3.18 It is necessary to focus on two particular elements of a contract of insurance when considering the nature of the arrangements entered into by the bank:

a) Do the arrangements involve a "specified event" which has some element of uncertainty about it?

b) Do the arrangements involve an element of speculation as to whether there will be profit or loss to the insurer?

c)Uncertainty_

3.19 **BGBW and RMcV have submitted that the -specified event" was the incurring of losses by the Bank, which had the requisite uncertainty as to both timing and amount. BGBW have further submitted that all that is required is some element of uncertainty: most aspects of the contract may be certain but as long as**

there is one element of uncertainty that is enough to have insurance.

3.20 **In Black's Law Dictionary, Henry C. Black, (6th ed., 1990), "uncertainty' is defined (at page 1524) to mean "the state or quality of being unknown or vague". Further, in Hickn v Peacey [1945] AC 304 (HL), Lord MacMIllan (at pages 321 - 324) in interpreting the word 'uncertain' (in the context of section 184 of the Law of Property Act 1925 (UK)), notes that "uncertain" in its ordinary everyday acceptance denotes "a reasonable element of doubt. so as to "satisfy the mind of a person of reasonable intelligence". Accordingly, uncertalnty is judged objectively. This requires an assessment of the circumstances in which the relevant uncertainty is claimed. BGBW and RMcV argued that these pronouncements in Hickman v Peacey were made in a case turning on the meaning of "uncertainty' in a section in the Property Law Act and have no relevance to the very different context of insurance. The Commission accepts that in the case of insurance it is sufficient to show that some element of** uncertainty is present. In determlning, however, whether that element of uncertainty exists the meaning of the word in other legal contexts is appropriate and as Hickman v Peacey shows the court approaches the task of defining uncertainty from the objectlve standpoint of reasonableness. In the present context it is for the court on the basis of reasonableness to determine this **question. It is not sufficient to look at uncertainty only from the subjective standpoint of the directors.**

3.21 There are three elements of an insurance contract which may have some degree of uncertainty about them:

(i) **event** and quantum of loss;

(ii) timing Of claims;

(iii) amount of the claims and payments

Each of these elements will be dealt with in tum.

(/} Event and quantum of loss

3.22 **BGBW and RMcV have submitted that the question of uncertainty must be looked at at the point at which the contract was entered into and that at the end of March 1988, while it was clear that losses would occur, it was far from certain as to when the losses would occur and what quantum they would be. In considering these manors it is necessary to take into account the surrounding circumstances and facts known to the Bank.**

3.23 **If these surrounding circumstances can properly be looked at it is apparent that the Bank already had general and specific provisions for doubtful debts of $195 million after finalisation of its March 1988 financial statements and after writing off bad debts of $161 million. The Bank's total book at this time was in excess** of $12 billion.

3.24 **In addition to the general and specific provisions for doubtful debts,the terms of the Bank's "indemnity" also covered the Bank for losses on investments, loss of returns and various other contingencies.**

3.25 We do not consider that there was any uncertainty that the Bank would be able to identify $200 million of losses under the arrangements.

3.26 black was in no doubt about this. He was asked whether he regarded the arrangements,`as an insurance policy. He said, at p.149:

> ***Yes I do because it is an insurance policy. ... we've said it was based on captive insurance pn.nciples. ... But the way it was structured and certainly looking at It from [a] 1988 perspective and the accounting principles applying in those days we believed It was. ... How it was utilised ... wouldn't have mattered. The point Is that we put something in place that it didn't matter whether it wasn't used at all because we had an assurance***

Ind would be able to get our money back together with Interest thereon.

and, at p.150

> ***That's not unusual in terms of financial captive insurance. I mean there's nothing unusual about that.***

3.27 **Asked whether it was his expectation that, whatever happened, whether there were claims or not, the Bank would get its money back at the end of the five years, Diack said at p.150:**

> ***Absolutely. That's why we made the claim. We didn't have to worry about whether there were claims or not. We made it so wide that there would almost certainly be able to be claims at the end of the day.***

3.28 **At p.147 Diack said in answer to the question whether it was totally open to the Board to decide at any time, no manor whatever happened to the economy, to make a claim even on the second day of the five year term:**

> ***Yes that's exactly right in that respect. That's why it was a five year insurance policy. We could claim, we know that we couldn't get paid as we know, but we could certainly claim at any stage In that five year term.***

3.29 **We observe that, in the first nomination of "specified debts and specified investments_ for indemnification under the policy, made by the Bank on 20 December 1988, approximately $420 million of debts and investments were identified.**

3.30 RMcV drew attention to evidence given by Lojkine (p.940 of transcript) that it was possible that at some point in the future a larger claim might need to be made under the policy. That evidence must however be placed against other evidence from Lojkine which indicated that there was no uncertainty in her mind that the Bank would always be in a position to recover the full $200 million under the policy. At p.947 Lojkine states:

> ***... my view was that whether or not we had only unexpected ones [i.e. claims} we would certainly have some claims. We were certain to be able to recover it against bad or doubttul debts one way or the other. So, it was not, it was certain, that we would be able to make the claims that we were required to make.***

At p.980:

> ***The bad and doubtlu! debt provisioning history indicated that we would always have enough to get the money back, but my understanding was that we couldn't get it back unless we had a valid claim. So yes in that sense, yes, there was a risk but in my opinion it was negligible.***

3.31 **The nature of the arrangement as described in McCay's memorandum to the board dated 30 March 1988 in clauses 3(g) and S was such that the amount of the zero coupon bonds into which the premium was invested matched on maturity the maximum amount of cover under the policy, and these bonds were said to be "held on trust for the benefit of the policyholder". Directors on the basis of this memorandum were assured that the bank would recover the whole of the present value of the -amount outlaid. It would have been a matter of concern were there any real possibility of the bank recovering less than this.**

3.32 **BGBW and RMcV submitted that under the insurance documents if a recovery was made by the Bank in respect of which a claim had previously been made by it, and paid, then the Bank was legally obliged to pay the money over, in which case the Maximum Insured Amount would be reinstated to that extent. Clause 3.8 of the Insurance Policy (and the corresponding provisions in clause 3.8 of the Deed of Indemnity and of the Reinsurance Policy provide that:**

> ***Any recoveries alter a claim is accepted but not paid shall reinstate the available Maximum Insured Amount to that extent. Any recoveries-alter a claim is paid shall be paid to the Insurer and shall reinstate the available Maximum Insured Amount to that extent.***

It was argued that by reason of this provision it could not be said on 30 March 1988 that there was certainty that the Bank would have been able to recover the full $200 million. If economic conditions had markedly improved and debts claimed under the policy were later received by the Bank the policy would have had to be reinstated to that extent. There may, it was submitted, have been a reasonable expectation on the part of the Bank that it would be able to recover the full insured amount but it was not a certainty.

3.33 **The nature of the arrangement as set out in the contemporary documents and the way in which both management and, as indicated by Lojkine's evidence, the Board itself, understood and intended the arrangements to have effect, do not support this argument. In addition it is not without significance that the Bank under clause 7.3 of the Deed of Indemnity was under no obligation to pursue any matter which had been brought under the policy as a specified debt.**

(ii) Timing of claims and the amount and payment of claims

3.34 **BGBW submitted that there was uncertainty as to when claims would be made (and for what amount) and this is why an 'Auditor's Certificate" was required evidencing losses by the Bank.**

3.35 **It is important to observe that claims made by the Bank (whenever made) are to be paid on certain known dates. In the context of any uncertainty in the arrangements as between parties the timing of claims in the present case is itself not of real significance. It is the timing linked to a known date for payment which is important. The two must be looked at together. The timing of claims may have an accounting significance for the insured but this is of no significance to the insurer who knows with certainty that the claims whenever made need be met only on certain known dates.**

3.36 The Deed of Indemnify requires BNZ to aerve an "Indemnity Notice" advieing the Indemnifier that BNZ wiehes to be indemnified in reepect of certain of the Specified Debts and Specified Investments earlier nominated. However, to be valid, an Indemnity Notice muei be accompanied by an Auditor'e Oeriificate (by virtue of the definition of the Indemnity Notice).

3.37 The Deed of Indemnity eats out the procedure for the bank to make claims against the Indemnifier (BNZS). Under clauee 3.2, the Indemnifier can either pay the indemnified amount within 14 daye of receiving the Indemnify Notice (and Auditor'e Oertificate) or notify BNZ that it electe to defer payment in whole or in part until a later date being a date no later than the expiry date of the indemnity i.e. 30 March 1993. This clause enables the Indemnifier to choose when it wiehes to meet claime (within the overall duration of the policy).

The Deed of Indemnity, on the face of it, provided that claime could be made at any time (and for any amount up to the maximum eum indemnified of $200 miHion). However, as stated earlier, we coneider that the intention of the partiee wae eet out in a memorandum dated 29 March 1988 from Mark Jones to Diack and Dowland referred to in para 3.8 above and in clauee 3(h) of McCay's memorandum eat out at para 2.15. The latter memorandum states that the policy is structured so that while claims may be made by the Bank and accepted by the indemnifier the maximum amount payable for the first four years is restricted to $10 mutton per annum in years 2, 3 and 4. The balance of $170 mHHon ie payable in year 5. Jonee' memorandum givee the actual dates namely 31 March of each year. Theee deice were consieteni with the maturity dates of the bonds/deposit. It is interesting to compare those dates with what actually happened. The Bank has made claims (pursuant to an Indemnity Notice accompanied by an Auditor's Certificate) for $10 mOlten each for payment on 30 March 1990, 26 March 1991, 31 March 1992 and for $170 million for payment on 25 March 1993.

3.38 **Consistent with this arrangement and understanding, BGBW acknowledged that:**

> ***Now certainly the reality was that over the five year period it was going to make sure it made these claims otherwise it is just throwing away its money and equally clearly, however much it claimed and when, It wasn't going to get paid other than on the 10, 10, 10, 170 formula ...***

Counsel went on to say:

> ***... but in my submission all we need is the element of uncertainty and that's satisfied by the lack of clear knowledge at 30 March 1988 just when these claims are going to be made and at what amount. That's the uncertainty. As I say in the outline the definition does not require that payment should take place immediately upon the making of the claim.***

3.39 The uncertainty to which BGBW refers is on a matter which was not significant as between the parties in terms of the total arrangements. It was of little consequence (except to the Bank in an accounting sense) that the Bank could at any time make claims under the policy when it was known:

Ca) that the Bank would always be in a position to claim the amount of the losses prior to the respective dates for payment; and

(b) that these claims would not be paid except upon certain known dates with the major part of the payment ($170 million) coming at the end of the five year period.

3.40 Although the Deed of Indemnity gave the Indemnifier discretion to pay on any date before 30 March 1993, the actual arrangements as confirmed by McCay's memorandum to the sub-committee of the Board of 30 March 1988 limited **payment dates to the maturity dates (and amounts) of the deposit. Thus the $200 million face value of the bonds/deposit represents the total amount of the indemnity under the arrangements.**

3.41 **The reality of the situation was that the Bank was paid $10 million each on or near 31 March 1990, 31 March 1991,and 31 March 1992 and was paid $170 million on 31 March 1993. These are the amounts which the Bank has claimed.**

3.42 By comparison the Bank has taken the benefit of the following amounts into its accounts:

$40 molten on 31 March 1989

$94 molten on 31 March 1990

$38 motion on 31 March 1991

$6 molten on 31 March 1992

$22 million on 31 March 1993

3.43 The Bank's failure to make claims for the actual amounts for which it took benefit into its financial statements raises further doubts over whether there was ever any uncertainty about when the Bank would make claims and the amount those claims would be for.

Investment Component

3.44 RMcV submitted that the Commission must not be influenced by what it considers to be the substantial investment component of the policy:

> ***Considerable emphasis has been placed, in our submission wrongly, on the timing of maturity of investments (placed by BAB V and EPUL with Da,.-/chi) and payments made under the policy. These types of investments are a very common feature of financial insurance and reinsurance. They are a sensible and prudent way of ensuring that when and if claims are made under a policy, there are likely to be sufficient funds to satisfy those claims.***

RMcV referred to the decision of the Court of Appeal in Marac Life Assurance Ltd v CIR [1986] 1 NZLR 694, as a case where the court unanimously

concluded that the life bonds in that case were life insurance policies, notwithstanding the investment component. In that case Richardson J. stated at 705-706:

> ***It Is not sufficient for Mr Jenkln's argument to say that the Marac life bonds involve the investment Of moneys. It may readily be accepted that each bond was entered into as an Investment. But in one sense that is true of all life Insurance. indeed whole of life and endowment insurance with participation In bonuses Is not readily explicable except as being designed partly as securing an ordinary investment return - fixed death cover alone may be provided by simple term Insurance. The principal question must be whether the transaction is properly character/sad as a contract of life Insurance (or endowment insurance), not whether the expected or guaranteed return makes It a good investment If the Investor surviVes to maturity when the return is compared with straight lending transactions. investors are free to enter into whatever lawful financial arrangements will suit their purposes. They cannot be treated as having entered into a different arrangement which would or might have achieved somewhat similar economic advantages and whether or not they ever had that alternative In contemplation. If Marac life bonds are policies Of life Insurance that is the end of the Inquiry.***
>
> ***The true nature Of the transaction can only be ascertained by careful consideration of the legal arrangements actually entered Into and carried out: not on an assessment of the broad substance of the transaction measured by the results intended and achieved or of the overall economic consequences.***

3.45 The Commission accepts that in determining whether the arrangements in the present case are to be described as a contract of insurance, it must do so on the basis of the legal form of the arrangements, and not their broad substance or economic consequences. It is, however, in the Commission's view on the basis of their legal form that the present arrangements can be distinguished from the insurance arrangements considered in the Marac case. In that case the court was unanimous in holding that the life bonds had an element of uncertainty depending on the contingencies of human life. Although the sum payable on maturity was calculated by adding to the premium a given percentage and compounding the resulting figure if necessary, it was only if death occurred on an exact anniversary of the commencement of the risk, that the sum paid would correspond to the premium and interest for the actual use

of the money. All of the bonds were in this way dependent on the contingencies of life. In the Commission's view the arrangements in the present case do not have that element of contingency or uncertainty.

Exrri.nsic Evidence

3.46 RMcV put before the Commission an expert opinion on the nature of the insurance arrangements provided by Mr P.A. Bawcutt, Managing Director of Risk & Insurance Research Group Limited, an independent firm of international consultants. Bawcutt is an acknowledged international expert on captive insurance and contracts of financial reinsurance. Bawcutt, from an examination of the insurance contracts, expressed the view that the contracts in this case came within the definition of insurance in Prudential Insurance Co v IR (supra). In particular because there was uncertainty as to whether the insured event would happen, if the event is one which must happen at some time, there was uncertainty as to the time at which it would happen. In reaching that conclusion Bawcutt and also.BGBW placed weight on the fact that there was nothing in the contract documentation requiring payment in accordance with the 10.10.10.170 formula. Furthermore, in the event of there being no claims under the policy or claims of a relatively low amount the excess of premium and investment income over the claims payments is returned to the insurer at the end of the contract period. Counsel referred to clause 2.6 of the trust agreement which EPUL has with EPTCHK which was set out in para 3.11.

Accordingly, it was argued, any excess was to be paid not to the BNZ (or BNZS), but rather to BABV and EPUL in their respective proportions.

3.47 BGBW in their final submissions also referred to the terms of the documents themselves as confirming the Bank's submission as to uncertainty. BGBW referred to the right of subrogation arising in favour of the insurer and reinsurer under insurance policy IA clauses 3.5, 8 and 10 against the Bank's debtors where claims are made by the Bank under the deed of indemnity and referred

also to the requirement under clause 3.5 of the insurance policy and the corresponding provisions of the deed of indemnity and the reinsurance policy which require that any recoveries made by the Bank are to be paid to the insurer and to reinstatement of the available maximum insured amount to the extent of any recovery. Bawcutt in his second letter dated 21 April 1993 in supporting his opinion that at the time the policy was taken out there were unoertainfies which would indicate an insurance policy as defined by the various cases and opinions available, has placed weight on the fact that there was nothing in the contract documentation which relates to what may have been the expected payment schedule of 10.10.10.170 and that there was not contained in the contract documentation a mechanism whereby the excess of premium and interest income over the claims payments would be returned to the insured at the end of the contract period.

3.43 There is force in Bawcutt's and BGBW's arguments if the terms of these documents are read alone without reference to the explanatory memoranda and surrounding circumstances. Read in this restricted way the contracts are arguably in the form of a contract of insurance. It is, therefore, important to consider whether it is permissible for the Commission in examining the legal form of the arrangements to have regard to this extrinsic evidence.

3.49 It is well recognised that parol evidence is not admissible to contradict or vary the meaning of a written insurance policy because after the contract is reduced into writing, the parties are not at liberty to show, by giving evidence of what passed between them at the time of effecting the policy, that they contracted otherwise than in accordance with the words which they have chosen to express the terms of their agreement: Hardy Ivamy, General Principles of Insurance Law 5th ed, 1936 225. There are, however, a number of well established exceptions to the parol evidence rule. Two relevant exceptions are that extrinsic evidence is admissible to prove that the policy does not accurately set out the actual terms of the agreement between the parties, and secondly to supplement the contract by adding collateral terms: A.M. Bisley & Co Ltd v

Thompson [1982] 2 NZLR 696, 702-703, CA.

Wr/'t!'nq not intended to ***be the*** *entire contract* ***between the part/.es***

3.50 Hardy Ivamy on the law of insurance summarises this exception to the parol evidence rules as follows:

> ***Where the question arises whether the policy as issued contains the real contract agreed between the parties, the court must necessarily refer to what passed between them during negotiations, including any preliminary documents, such as a prospectus, a proposal or a slip, in order to discover whether there was ever, in fact, a completed agreement and if so, what were its precise terms.***

Chitty On Contracts 26th ed, 1989 vol 1, para 847 states the exception in these words:

> ***In particular, since the nineteenth century, the courts have been prepared to admit extrinsic evidence of terms additional to those contained in the wn.Hen document if it Is shown that the document was not intended to express the entire agreement between the parties. So, for example, if the parties intend their contract to be partly oral and partly in writing, extrinsic evidence is admissible to prove the oral part of the agreement. In Gillespie Bros & Co v CheneyL Egger & Co, Lord Russell C.J. stated -... although when the parties arrive at a definite written contract the implication or presumption is very strong that such contract is intended to contain all the terms of their bargain, it is a presumption only, and it is open to either of the parties to allege that there was, in addition to what appears in the written agreement, an antecedent express stipulation not intended by the parties to be excluded, but intended to continue in force with the express written agreement- It cannot therefore be asserted that, in modem times, the mere production of a written agreement, however complete it may look, will as a matter of law render inadmissible evidence of other terms not included expressly or by reference in the document. ~The court is entitled to look at and should look at all the evidence from start to finish in order to see what the bargain was that was struck between the parties. ~ .' J. Evans & Son (Portsmouth) Ltd v Andrea Merzario Ltd [1976] 2 A Al! ER 930.***

3.51 When the surrounding circumstances to the arrangements entered into by the bank are considered there are several indications which tend to show that the

parties' entire contractual intentions are not contained in the written documents. In particular:

a) the memorandum referred to in para 3.8 above from Jones to Diack and Dow|and dated 29 March 1988, prepared at the time the documents were final|sad and described as a "Settlement Memorandum, sets out the initial bond arrangements and records the specific dates on which the bank "can make a claim" under the policy.

b) paragraph S of the memorandum dated 18 March 1988 from McCay to the Board seeking the approval of the Bank's board to the arrangements states:

> *The benefit of establishing insurance cover is to avoid the Impact on profit of* a *large wn.te-off in any one year by spreading the risk more evenly through the payment of an annual premium. Effective cost of the programme and the five year period is similar to wrltingoff the same amount of debt but smooths the reported profits.*

This paragraph contemplates the recovery of the full insured sum over the course of the five year period and treats the effective cost of the programme as being similar to the writing-off of the same amount of debt i.e. the present value of the premium spread over a five year period.

(c) the memorandum dated 30 March 1988 from McCay to the sub-committee of the board provides what are described as "details of the policy" and was provided at the time that contract documentation was being finalised. it is important to observe that the board was not provided with copies of the contract documents and relied entirely on this memorandum and the **memorandum referred to in (b) as providing adequate particulars of the documentation to which it was proposed to commit the Bank. Paragraph 3(h) of this memorandum describes payment under the policy in these terms:**

> ***Payment:** __the policy is structured__ so that while claims may be made by the Bank and accepted by the indemnifier nevertheless the maximum amount payable in the first four years of the policy is restricted to $lOm per annum In years 2, 3 and 4. The balance of $17Om Is payable in year 5.* **(emphasis added)**

Clause 5 provided details of the basis on which the single premium was to be invested by way of zero coupon bonds issued by prime institutions and the time at which those bonds would mature. It was expressly stated in this paragraph that-the bonds are held in trust for the benefit of the policy holder".

Neither of those details were contained in that form in the formal contract documentation but they formed the basis on which the board was invited to approve the entry by the bank into the contractual arrangements and it is apparent from the memorandum referred to in (a) above also formed the basis on which senior bank management was prepared to put the proposal forward.

(d) The memorandum of 15 March 1988 was prepared by Diack and although Diack was not clear in his recollection McCay's evidence was that the memorandum of 30 March 1988 was most likely prepared by Clack. The evidence received by the Commission was that Diack was the person within the Bank who dealt with EP and discussed the structure of the arrangements was Jones. The particulars set out in these memoranda on Diack's evidence represent what he understood to be the proposal coming from EPBC.

(e) the memorandum dated 31 March 1988 from Jones to the EPBC board was prepared at the time that board was being requested to approve the transaction. It describes the transaction in paragraph 17 which concludes the sections set out at para 3.8 above. This description also sets out in 17.3.4 the details as to the timing of payment of the bonds corresponding

to the dates in the Jones memorandum to Clack and Dow|and. The EP board was also informed in para 5:

> ***Security:* Assignment of zero coupon bond to a trustee for the benefit of SNZ as policyholder.**

(f) It is significant that the two directors who had a clear recollection of their appreciation of the nature of the arrangements at the time they were entered into both regarded the arrangements as having the feature that the Bank would over the course of the policy be entitled to recover an equivalent amount of the present value of the sum which it was required to pay.

3.52 **In the Commission's view the details of the arrangements which are set out in these memoranda are foundational to a proper understanding of the nature of the arrangements and were so regarded by the board and senior management of the bank and it would also seem from (d) above the board of EPBC. The particulars as to the timing of payments and the making of claims are not inconsistent with the provisions of the formal documents and the broader discretions set out in the formal documents should be read as limited in order** to accord with the intentions expressed in these memoranda. There is one respect in which there is inconsistency, namely the reference in paragraph 5 of McCay's memorandum of 30 March 1988 to the bonds being held in trust for the benefit of the policy holder. This is consistent with the provisions of the deed of trust between BV and EPTCHK (although that Deed should possibly be rectified in this,respect, see para 3.12 above) but is inconsistent with the provisions of the deed of trust between EPUL and EPTCHK An inconsistency on a matter on which a clear representation was made to the board of both the bank and EPBC would in the Commission's view afford strong grounds on which a collateral contract could be asserted of which this representation forms a term.

Collateral Contract

3.83 **The particulars set out in the memoranda which do not form part of the formal contract documents may be said to form terms of a collateral contract or series of collateral contracts to which the Bank and BNZS are parties respectively.**

Where a party is induced to enter into a contract on the basis of certain representations as to the nature and effect of that contract the court may treat those representations as being the terms of a collateral contract which are enforceable at the suit of the representee. Extrinsic evidence may be referred to in support of such a collateral contract: A.M. aisleo Ltd v Thompson (supra). In the Commission's view the express representations in the memorandum to the sub-committee of 30 March 1988 which are described as -details of the policy. form strong grounds for asserting a collateral contract in the present case.

3.84 Although a collateral undertaking which directly contradicts a primary provision in the written contract will not be enforced, the Courts will give effect to a contradictory collateral undertaking which merely varies an aspect of a written contract without being directly contradictory of its primary purpose: A.M. Bisley & Co Ltd v Thompson (supra) at 701-702. In the present case the representation made to the board of the Bank that the bonds would be held on trust for the policyholder (the Bank), although this representation may not be consistent with the terms of the Deeds of Trust, was not directed to the -primary purpose' of the arrangements and so can be given effect pursuant to a collateral contract. This contract would require EPBC, and its related company EPTCHK, to procure that EPUL and BV respectively held any available surplus on the termination of the arrangements on a further trust for the Bank.

3.88 N.M. Superannuation Pty Ltd v Younq (1993) 7 ANZ Insurances Cases 77871. After coming to the views expressed in the preceding paragraphs the Commission's attention was brought to the recent decision of the Federal Court

of Australia, given on appeal from the judgment of a single Federal Court judge. If this case is accepted as authoritative it provides support for the arguments addressed on behalf of the Bank and the directors represented by RMcV.

3.56 **This case concerned whether a payment made to a bankrupt from a superannuation fund administered by a life insurance company was protected from being an asset in the bankruptcy divisible among creditors by reason of certain statutory protection given to policies of assurance or endowment assurance. The question before the Court was whether the particular superannuation plan in the present case was a policy of assurance. The Federal Court on appeal reversed the trial judge and held that there was a sufficient element of uncertainty in the sense in which that word was used by Channel! J. in Prudential Assurance Co v CIR (supra) for the contract in this case to be a contract of insurance. The uncertainty as to time of claims and of the amount and payment of claims were, as in the present case, insubstantial, but the court was prepared to accept them as being sufficient for it to treat the contract as being one of insurance. The superannuation fund entitled the bankrupt to payment of a benefit in any one of three circumstances:**

1)on retirement after age 65

2)on death before the age of 75 while still in employment, or

3)) on leaving employment before retirement date.

One of these three events would have to affect the employee. There was no uncertainty about that fact. The amount payable on the happening of any of these events was also certain. It was the amount of the employer's
contributions together with interest to the date of payment.

3.57 **The court found uncertainty by looking separately at each of the three events giving rise to payment. The bankrupt might die before reaching retirement date and receive no benefit under that clause. He might retire before death and so receive no benefit under that particular clause. It was hold that the fact that the quantum of benefit would be the same in each case did not affect the outcome.**

3.58 **In this case the court was prepared to treat manors of a very tenuous kind as providing evidence of uncertainty. The context in that case can, however, be distinguished from the present arrangements. There was a real element of uncertainty as to the time at which the bankrupt would be entitled to payment of a benefit. It could not be known at the time the contract was entered into whether the bankrupt would be able to receive a benefit on death, or on** retirement, or upon his leaving employment. There is no such uncertainty in relation to the present arrangements. The time at which payments would be made was determined at the outset of the arrangements.

3.59 There are also grounds tor treating the NM Superannuation case as being a case which was decided in the special context of insolvency legislation and should be limited to those tacts and not given a wider application. Tho decision was given in the context of insolvency legislation the policy of which was to encourage investment in lite insurance. Hill J. at p. 77881 states:

> ***....there has existed in Australia for in excess of 100 years a policy of encouraging the investment in life assurance by affording to the policies of life assurance and endowment a limited protection in the event of bankruptcy.***

Burchett J. after a detailed examination of the history of the legislation says at p. 77874:

> ***This survey of authority, which is far from exhaustive, shows that provisions from which 5.116(2)(d) derives have been consistently regarded as of a beneficial or remedial nature. That bn'ngs the provision within a well known rule. It should not be construed in any narrower or more restrictive sense that its language would fairly allow.***

This policy factor, which clearly influenced the approach of the Court in the NM_ Superannuation case, is not present in relation to the present arrangements.

(b) Are the arranqements a contract of speculation in relation to the insurer?

3.80 It is clear from paragraph 5 of McCay_s memorandum to the sub-committee dated 30 March 1988 that the single premium to be paid by the Bank under the arrangements was intended to be invested in zero coupon bonds which would produce an income of $90 million so that the present value of the premium would represent the maximum insured amount of $200 million. In this paragraph the memorandum provides:

> **5** ***The single pram/um is invested in zero coupon bonds issued by pr/me institutions. The bonds will mature as follows $lOm per annum in year 2, 3 and 4 and $170m in year 5. The bonds are held in trust for the benefit of the policy holder.***

The only risk, therefore, carried by the insurer was an investment risk. RMcV put forward in evidence an opinion from Bawcutt. In a letter dated 8 April 1993 in which Bawcutt expresses certain views on the present insurance arrangements he states:

> ***The poss/bi//ty Of the insurer and re/nsurer making an underwriting loss or a significant underwriting profit are obvious character/st/cs of an insurance contract and would certainly fit wail within the definition of Insurance in the classic judgment of the judge in the case of Prudential insurance Co v /RC 1904 ...***

Bawcutt refers to the possibility of the insurer and reinsurer having the opportunity (when regard is had to the wording of the policy documents in this case) of making a substantial profit and he referred to the absence of a mechanism (unlike many financial insurance contracts) whereby the excess of premium in investment income over the claims payments is returned to the

insured at the end of the contract period. Bawcutt does not, however, refer to any risk of loss on the part of the insurer, other than a reference in a further letter dated 21 April 1993 to:

> ***the possibility of a risk to the Insurers, In the early contract years, when the premium payment plus Investment Income might not meet the/eve/of claim payment.***

and to what he describes as a significant withholding tax risk in the event that withholding tax becomes payable on the investment placed with DKB.

The question arises whether an investment risk of this kind carries the speculative element which is required of a contract of insurance. There does not appear to be any real possibility of a loss upon a speculation arising to the insurer in the present case. Lojkine recognised that this significant element of an insurance policy was missing in the present case. in p.946 of the evidence **she states:**

> ***I don't consider It was an Insurance arrangement as one commonly understands the term because that normally Involves a much smaller payment by the Insured and a gamble as to whether or not some larger sum will have to be paid back. In this case there was no gamble. It had only In common with Insurance the fact that the advice was that the single premium would be deductible and that you deducted It over a period of years and recovered when the event takes place which was covered.***

3.61 The need for a contract of insurance to have a speculative element has long been regarded as one of the fundamental features of the contract. The passage cited in para 3.16 from McGillivray on insurance requires that the insurer be exposed to the risk of both profit and loss. This element was referred to by Tindal C.J. in Paterson v Powell (1832) 9 Bing 329 in these **words:**

> ***Our decision, therefore, in this case, must tum on the provisions [of the Act of 17741, if this instrument can be deemed a policy. Upon that point we entertain no doubt. Here is a premium paid in consideration of the insurers incurn.ng the risk of paying a larger sum upon a given contingency.***

3.62 **This principle has been applied in the United States as recognised by Richardson J. in Marac Life Assurance Ltd v Commissioner of inland Revenue [1986] 1 NZLR 694,705. Although it was not necessary in that case for him to express any view on the issue in relation to the law in New Zealand, Richardson J. stated:**

> ***... nor is it necessary to review the emphasis placed in some American authorities on risk-taking by the insurer as inherent in the concept of life insurance.***

The American cases cited to the court included Helvering v Le Gierse 312 US 531 (1941), Zimmerman v C.I.R. 241 F 2d 338 (1957 CA 8) and S.E.C. v Valic 359 US 65 (1959).

3.63 **However, a recent appellate decision of the Federal Court of Australia doubts whether the incurring of the risk of both profit and loss by the insurer was a necessary feature of a contract of insurance and further held that if such an element was required it was satisfied by the presence of an investment risk. This case, NM Superannuation Ply Ltd v Younq (supra) was discussed earlier in another context.**

The trial judge (Van Doussa J.) held on the facts of that case that there was no risk of profit or loss to the insurer. The risk incurred was no more than an ordinary investment risk such as would be incurred on any term savings` or investment contract. At p. 77504 of the report of the case at first instance [(1992) 7 ANZ Insurance Cases 77493], Van Doussa J. after citing the above referred to passage from McGillivray, stated:

It is a characteristic of a contract of insurance that the amount of the premium is not intended to be equivalent to the present value of the insurer's actualperformance; McGHlivray and Parkington on Insurance Law 7th Ed at p.3. And conversely the insurer's actual performance, the payment of the sum insured on the happening of the contingency, is not intended to be equivalent to the value of the moneys paid to the insurer by way of premium.

That a contract of insurance involves an element of speculation Is not, of course, a sufficient criterion for distinguishing a contract of insurance from contracts of some other kind. .There is an element of speculation in contracts of surety&hip and in warranties as to the quality or performance of chattels, but the absence of an element of speculation which carries & risk to the putative insurer that the contract may be worth more or less than the value of the premiums received indicates that the contract Is not one of insurance.

With reference to the policy taken out by the debtor in the present case the learned Judge stated at p.77504:

In no relevant sense was National Mutual exposed to a risk that it might suffer a loss. The contract did not contemplate that at any time would there be a chance that National Mutual would benefit or lose according to when the death of the bankrupt occurred. The contract contemplated that money would be received by National Mutual in respect of the bankrupt's interest in the Fund, that the money would be invested by it, and that whenever the time for payment of a benefit arose the moneys received together with accrued interest would be repaid.

A capital guaranteed investment, offered for example by a bank or other financial institution to its clients, would not normally be considered to involve a contract of'insurance with the client. The financial institution provides to its clients an investment service. ... In these situations, the happening of the event which would require the provider to meet the guarantee would usually be uncertain, yet the contract would not be one of insurance as the event is not one outside the control of the provider.

3.64 The Court on appeal reversed the judgment of Van Doussa J. on this and other issues. Hill J. who delivered the leading judgment doubted that there was any case authority to support Van Doussa J.'s views and held that if risk to the insurer is a necessary requirement of an insurance policy, such risk exists in

that the insurer may not be, in fact, able to obtain the interest made, but will nevertheless remain liable to pay the sum on the happening of the risk. It was held that there was a sufficient element of risk in that the policy ensured to the person insured a benefit greater than the premium paid.

3.65 If the authority of this case is accepted in New Zealand it does provide support for the argument advanced on behalf of the Bank and the directors that the insurer under the arrangements entered into by the Bank assumed a sufficient risk for the arrangements to be described as insurance. It would be difficult to distinguish the type of risk here assumed by the insurer from that in the NM_ Superannu__ation case.

3.66 The Commission has been informed that application has been made for leave to take this case on appeal to the High Court of Australia. In the Commission's view the correctness of the decision is open to serious doubt. It fails to deal with the issue raised by the trial judge in distinguishing between investment contracts and contracts of insurance. If the appeal court is correct virtually every savings bond or term investment contract has a sufficient element of risk on the part of the insurer for the contract to be one of insurance. The borrower in these investment contracts takes the risk of being able to make a sufficient return on the invested sum to make payment of the agreed figure on maturity.

3.67 In addition for the reasons advanced earlier in para 3.56 the NM_ Superannuation case should be treated as a case turning on its own special facts and limited by the particular statutory context in which it was decided.

Conclusion

3.68 The Commission concludes that when regard is had to all the surrounding documents and circumstances it is doubtful whether the arrangements can properly be described at law as a contract of insurance. We do not consider that the formal documents evidenced the complete agreement between the

parties and the memoranda passing between Jones and senior management of the Bank and memoranda presented to the respective Boards of the Bank and EPBC and the surrounding circumstances must be looked at to determine the true nature of the arrangements. In addition there was no sufficient element of speculation or risk as far as the insurer was concerned for the arrangements to be a true contract of insurance. The issue is not beyond doubt because of the width of the pronouncements in a recent decision at appellate level of the Australian Federal Court. We have doubts as the proper basis of that decision but if its authority is accepted there may be grounds for treating the present arrangements as being a true contract of insurance.

3.89 We are of no doubt, however, that when the broad substance and economic consequences of the transaction are examined, measured by the results intended or achieved by the parties, the arrangements were not in substance an insurance policy but a form of investment. We deal with that question in more detail later in this report.

4.0 WERE THE PROCEDURES FOR APPROVING THE ARRANGEMENTS ADEQUATE?

The arramanta

4.1 The contractual documents do not, as observed at paragraph 3.45, contain all aspects of the arrangements as approved by the Board. Moreover aspects and details of the arrangements were omitted from McCoy's memo of 30 March 1988 (see para 2.15):

(a) the memorandum did not say that the proceeds of the premium were initially to be invested in securities issued by the publicly listed subsidiary of the Bank, BNZF. It was several months before the funds were placed on deposit with a major Japanese bank;

(b) **the owner of the insurance company, described in the memorandum as "Kreditbank", had a put option back to an EP company;**

c) the nominal owner of the insurance company was a Luxembourg associate of the major Belgian banking group, Kredietbank NV;

d) the Netherlands insurance company was "reinsuring" 90% of its risk with a member of the EP group;

(e) the Bank was to incur total costs of around $1.65 million as s consequence of entering into and participating in the arrangements, of which $1.15 million would be fees payable to EP Group companies, $100,000 comprised professional fees, and $250,000 covered the fees payable to Kredietbank, the nominee directors and the costs of establishing the insurance company vehicle in the Netherlands. An additional $150,000 was payable to BNZF.

4.2 Members of the subcommittee of the Board which met on 30 March 1988 (see para 2.15) said in evidence to the Commission that they may have felt differently about approving the Bank's participation in the arrangements if they had known about the additional details including the put option granted to Kredietbank. Bayliss said at p.908:

> *..there ware some vely experienced people on the Board and I think if they had seen the full detail of this thing that they wouldn't have been happy and I certainly wouldn't have been happy myself. I find it difficult to believe that if I had known what I know now I would have willingly and gladly assented to the thing which I did. It never occurred to me that there was anything that wasn't completely above board in the proposal, a straightforward insurance proposal done with reputable and honourable people ...*

4.3 **Campbell said at p.810, when asked about the put option:**

> ***I was surprised when I read that. I don't be//eve I was aware of it at the time.***

When asked if he thought he should have been told about it the put option, Campbell said at p.811:

> ***Yes I dO.***

4.4 Lojkine, although not a member of the sub-commlnes, was asked if she was aware of the put option back to EP. She said she was not. Lojkine was asked whether, if she had been aware of the put option, it would have affected her final judgment about the Bank's participation in the arrangements. She said at p.946:

> ***I would have wanted to be sure that the money was .... under the control Of an organ/sat/on in which the Bank could have confidence. And provided that were the case it wouldn't really matter where it was. I mean, you understand the mechanics Of the scheme, so you know that the Bank's money was coming back to It.***

4.5 **The 30 March memorandum, together with the record of the sub-commiftee's approval and the earlier March 15 memorandum, were formally received by the Board at its meeting of 28 April 1988. Directors present at that meeting cannot recollect any substantive discussion on the matter taking place. The minutes of the meeting do not indicate there was any discussion.**

4.6 Although the decision to enter into the arrangements had been taken by that time, our view is that the additional material provided to the directors in April **(in particular the 30 March memorandum) was sufficient to alert those directors who attended the April meeting that these were unusual arrangements where the return was related solely to the proceeds of the investment of the premium in zero coupon bonds and where there was no transfer of insurance risk away from the Bank.**

DleOueelon8 with Profeeelonal advisers

4.7 **McCay's 15 March 1988 memorandum refers to "extensive discussions" having taken place with both the Bank's auditors and legal advisers about the "concept and practical application" of the proposal and of having their full endorsement of the "validity and viability" of the proposal "for the purposes intended". The 30 March 1988 memorandum refers to the 'close involvement" of the auditors and legal advisers and to the anticipated provision of appropriate legal and audit opinions.**

The Bank's auditors

4.8 **Mr P.A. Garty, partner of E & Y (then Ernst and Whinney), one of the Bank's two firms of auditors at that time, told us that he first became aware of the arrangements when he attended a meeting at the offices of Budfin late in the afternoon of March 30 1988. He recalls being shown draft documentation but was not asked to study it, to comment on it, or to express any views on the arrangements as proposed.**

4.9 **We also questioned Mr P.U. Macaulay, then senior partner in Ernst and Whinney, who recalls first being told of the arrangements by Garty following the 30 March meeting. He said at p.391 that he was given:**

> *An outline of, you could say an Intriguing and unusual financial device and you could almost say it was received by me with extreme apprehension.*

Asked the reason for this apprehension Macaulay said at p.391:

> ***Because of the intriguing and novel nature of it to me***

Macaulay said he had hat previausly encauntered a transact|an af this kind.

4.10 Mr P.A. Nankivell, af BOO, the Bank's ether firm af auditars at the time, said he did hat learn af the arrangements until same time later.

4.11 **Late in February 1988 Dawland made a mate af a number af manors he cansidered shauld be fallawed thraugh by Diack. These manors included that Diack shauld discuss the prapased arrangements with the Bank's auditars.**

4.12 Diack stated that he did have discuss|ans with the auditars prier ta the preparatian af the March 15 memarandum, but cauld hat identify any particular meeting. He said at p.870:

> *I'm convinced having wn'tten it I would have had some discussion. It may have been by phone, It may have been quite informal.*

4.13 **We are satisfied that any discuss|ans which may have taken place with the auditars prier ta the afternaan af 30 March 1988 were, at best, minimal. In cur view the directars af the Bank were misinfarmed an this aspect by McCay's twa memaranda. In cur view the respansibility far this lies primarily with the Investment Banking Divisian. Hawever Travers, the General Manager responsible far the Divisiam, has imfarmed us that he was hat persanally imvalved in the develapmemt af the arrangements.**

The Bank's legal advisers

4.14 We wauld expect ta find that the Bank had abtained extensive advice tram its legal advisers relating net anly ta the detail af the dacuments the Bank prapased ta sign, but alsa ta the effectiveness af the concept, including the requirement that the Bank wauld get its Marney back, and its viability far the purpases intended.

4.15 The Bank's legal advisers, Budfin, were involved in the preparation of the documents. Moreover we have been told that Budfin issued a certificate to **BNZS prior to the affixing of that company's seal to the Deed of Indemnity to the effect that it was in order and a proper Deed for signature, but neither the Bank nor Budfin can locate that certificate. Only an unsigned draft document** has been found.

4.18 **We have been told that Budfin was asked to give advice relating to some taxation aspects of the proposal but not aspects which were relevant to the issues raised by our enquiry. We have also been told that Budfin were not asked to give an opinion on the overall insurance concept or on the potential for the arrangements to be used as an income smoothing device.**

4.17 In our view the directors of the Bank were misinformed over the references to Budfin "fully endorsing the validity and viability of the approach for the purposes intended".

4.18 As would be expected the directors of the Bank gained comfort from the assurances given about the support of the Bank's auditors and legal advisers. Bayliss was asked if he got comfort from these assurances. He told us at p.904:

> *Yes. As a Board member then I had no reason to believe that it wasn't anything but a straightforward insurance proposition fully supported by expen.enced and knowledgeable Bank.executives with the support of the Bank legal and accounting experts outside and I just felt that it was an absolutely straightforward proposition.*

4.19 Campbell said at p.795 that the main concern of directors at the 17 March meeting was:

> ***...that the Bank was in receipt of appropriate audit and legal opinion as to the properness .... of the transaction.***

When asked if directors were told that this was the case he said, also at p.798:

> ***We// again my recollection strongly is that appropriate assurances were received that* [the Bank} *held both audit and legal opinion as to the proper nature of the transaction.***

The role of Buddie Findlay

4.20 **We note that two former partners of Budfin Wellington office acted for both the Bank and the EP Group companies at the time the arrangements were established.**

4.21 **Budfifl did not give evidence to the Commission. BGBW informed us that BNZ claimed privilege in respect of any advice given by Budfin. We decided not to challenge this claim. However we thought it necessary to consider whether it was appropriate for Budfin to represent both BNZ and the EP Group of companies in March 1988 in settling the documentation of the arrangements. On the manor Budfin submitted, in a letter to the Commission dated 26 February 1993:**

> ***(a) In the case of the credit insurance arrangements, as in other instances, there is nothing to prevent one firm of solicitors acting for more than one party to* a *transact/on with the pr/or consent of the part/es concerned.***
>
> ***(b) The firm acted for Bank of New Zea/and and European Pacific with the pr/or consent of both those parties.***
>
> *(c) This is not an unusual circumstance where two part/es to* e *transaction are working together to bring that transact/on to fruition and, because of the particular circumstances, do not consider Ir is necessary to engage separate counsel.*
>
> *Accordingly we do not think there Is anything to suggest it was improper or inappropn.ate for our firm to -act for the Bank and European Pacific. Furthermore, to raise the quest/on of whether* a *particular course of action is "appropr/ate", when there is nothing to suggest that it is not appropriate, may lead to incorrect conclusions being drawn ... .*

4.22 In a further loner dated 8 April 1993 Budfin added:

> (I) *We were initially Instructed by the Bank to act for it in relation to e transaction structured and put to it by EP. We were subsequently requested by EP to provide to It certain limited advice. The Bank's consent to our acting In this capacity was obtained*
>
> (ii) *Where a /aw firm accepts instructions to act for more than one party to a transaction it must be careful to ensure that such a role does not prevent it from providing Independent advice to Its clients. We are very mindful of this fact. We would not have agreed to act for both the Bank and EP if we had considered that such a course of action precluded the provision of Independent advice to the Bank. That Is fundamental to our position as solicitors. We are firmly of the opinion that as solicitors to the Bank on this matter we properly discharged our obligations.*

4.23 We observe that, while it is common in routine transactions for one firm of lawyers to act for both parties, this was a large, complex and highly unusual transaction involving the investment of over $100 million and the payment of around $1.1 million in fees by one party to the other. It was a transaction in respect of which BNZ management felt it necessary to assure directors that they had "extensively discussed the concept and practical application" with the lawyers and that the lawyers "fully endorse the validity and viability of the approach for the purposes intended".

4.24 The fact that both sides were agreeable to using the same partners of the same legal firm suggests that there was perceived to be some commonality of interest between the two parties.

4.25 The provision of an independent legal view would have assisted the Bank and its directors to comprehend the true nature of the arrangements.

4.28 In our view it would have been prudent for the Bank and the EP Group to retain different solicitors, or at least different partners within the same firm, to act for each side of the transaction in the particular circumstances. Nevertheless in

view of the Bank's consent for Budfin to act also for EP we do not consider it was improper for Budfin to receive instructions from both parties.

The payment of fees

4.27 **Bank directors and executives acknowledged in evidence that there was no potential for any cash benefits to accrue to the Bank from the arrangements other than investment benefits because the Bank would get back only its original -deposit" with interest and did not benefit from any transfer away of insurance risk.**

4.28 We appreciate that merchant banks were accustomed to charging high levels of fees during the late 1980's. However in our view the **fees** paid by the Bank appear high in relation to the potential benefits gained by the Bank.

4.29 **We have already noted that the Board memoranda made no reference to the level of fees payable by the Bank. Diack said that it was quite normal for that kind of detail not to be provided to the directors. However at least one director, Lojkine, can recollect being aware that EP was to receive fees of "around $800,000".**

4.30 **We have not been provided with any explanation for the level of fees paid by the Bank. We are informed that no cosenefit analysis was undertaken before** the contracts were entered into. We find this surprising.

4.31 We have been unable to ascertain who approved the payment of the initial fees, and whether the payment was within that person's authority. Diack says that he negotiated the fees in consultation with Travers. Travers says that he had no authority to approve fees of that order and was not involved in the negotiation process. He adds that as a director of EPI he would have had to disassociate himself from any negotiation of fees between the Bank and EPI.

In **our view, however,** it **would be surprising** if **Travers, who was general manager of the Investment Banking Division, was not at least aware of the** process.

4.32 What is clear is that the Board was not formally told of the level of fees payable and did not approve them.

The reaeons for the Bank entering.In be arramanta

4.33 **McCoy's memoranda identified several reasons why the Bank should enter into the arrangements. These were:**

15 March memo

> ***...to avoid the Impact on profit of a large wn.te-off in any one year by spreading the riskmore evenly through the payment of an annual premium.***
>
> ***...[to] provide the auditors with a degree of assurance when testing the adequacy of doubtful debt management.***
>
> ***...[it} may also provide comfort to rating agencies when assessing the Bank's credit standing.***

30 March memo

> ***...[it] provides the benefit of &voiding the impact on profit of a large write-off in any one year by spreading the risk through the &mortising of the premium over a 5 year term.***

4.34 **None of the present and former executives or former directors of the Bank who gave evidence before the Commission resiled from any of these reasons.** We **consider them in turn.**

Income smoothing

4.35 Diack said that the potential for income smoothing was the main justification for the arrangements and he was confident all the directors understood this. Diack said at p.143:

> ***...I felt that the reason for the establishment of the policy was to `take that one big hit whether it was a Judge ... or a Chase ... or an Equitlcorp....***

and at p.150:

> ***[It was]..there to protect [against] that one big hit In the next two to three years. ...***

4.36 While Lojkine, Pearson and Bayliss were uncomfortable with the income smoothing objective they did not have sufficient reservations to oppose the proposal. Lojkine said at p. 942/3:

> ***Well I disapprove in principle of Income smoothing.I have had in my somewhat limited career as a company director a number of arguments about profit smoothing, most of which have been in connection with the relationship between half yearly accounts and end year accounts...... .***
>
> ***But however there have also been arguments about profit smoothing between years and this Is one of them. I considered first that although the arrangement had something in common with an insurance policy in the sense that money was being spent now and deducted now which would come to credit In the event of an emergency of some kind; it was more in the nature of a sinking fund rather than an insurance policy. ...***

and further, at page 951

> ***...in genera! terms I disapprove of profit smoothing. In the circumstances of that time I don't necessan.ly think that was so abhorrent `given exactly where we were in relation to the share market crash and the assurances by management that we had provided every specific bad or doubtful loan, but there was just this feeling there could be others.***

and at p. 952:

We// to my mind it was a sens/b/e thing to do, not to overstate the Bank's profits for 1988 or if you remember in 88 they were saying... . Again in my view we were sensible not to overstate those profits in view of the fact that there was a possibility that we could have unexpected, unexpectedly larger than normal bad debts. .... If we had deducted the pro-rata share of the payment and, of course interest income was lower so approximately 40 million a year lower profit than we would otherwlse have shown. That would have been sensible as a form of provislonlng aga/nst future enormous bad debts.

4.37 Bayliss, on the objective of income smoothing, said at p.909:

...that seemed to me to be a pretty reasonable benefit to be aiming for and which would result from your bona fide Insurance proposition. That's what it appeared to me.

4.38 Pearson, on whether he was comfortable with income smoothing as a use of the policy said at p.1156:

No. ... I'm an investment analyst. ... No I wasn't no. But I nevertheless accepted the logic of the capita/ adequacy issue In the ... sense of going towards the BIS rules and all that kind of thing. I could see that, properly used, It was conceivable that there was a proper use for that at some point, possibly.

Assurance to the. auditors

4.39 The auditors have given evidence that the arrangements did not provide them with "...[any} degree of assurance when testing the adequacy of [the Bank's} doubtful debt management' as at 31 March 1988. We have examined the documents carefully. We accept this evidence.

4.40 There is evidence that the Bank's auditors had some regard to the existence of the arrangements when looking at the Bank's provisioning in subsequent

financial periods. This is dealt with elsewhere in this report.

Assu__r___once___st_o___*the*____*r*__*atl*
nqs.a~qencles

4.41

We questioned Bank executives on whether the ratings agencies were told about the existence of the policy. While those responsible for direct contact with the agencies said they were sure the agencies were aware of the existence of the arrangement, the Bank has been unable to provide any documentary evidence that the rating agencies were informed about the

4.42 Mr C.P. Purvis, Chief Manager Group Accounting, told us at p.1217:

> ***1'm not sure If it would have provided comfort to the credit rating agencies.***

When asked why not, he replied at p.1218:

> ***I think the credit rating agencies would have seen It as what It was, just an income smoothing device.***

4.43 We agree with Purvis.

Tho hoote to put the orrongemento In piece

4.44 **McCay's 15 March memorandum, in recommending the establishment of a Board sub-committee to approve the Bank entering into the arrangements, referred to the "..obvious benefits in putting the insurance cover in place and effecting the premium before 3lst March`.**

4.46 **We questioned directors and management on what these "obvious benefits" were. We were conscious that if the Bank was to make any use of the benefits available under the arrangements in the year ended 31 March 1988 they would have had to be in place before then.**

4.48 **Evidence from some of the witnesses indicated that,** in **their view, the arrangements were not "tax-driven" and that the capacity for income smoothing was the main attraction of the proposal.**

4.47 However some others, including Lojkine and Diack, saw the promise of tax benefits as the "obvious benefits" to which McCoy referred. Lojkine told us at **p.939;**

> ***My impression was that the Bank management thought that they could get a tax deduction In the 1988 year for either the whole premium or ... certainly one year's share of it, regardless of what was done for accounting purposes. My impression was that the matter had been brought to their attention rather at the last minute and that they were scrambling to try to take advantage of what they thought might be an advantage, a benefit to the Bank before 31 March.***

4.48 **Diack said that the Bank had hoped to be able to expense one fifth of the total premium, $22 million, in the year ended 31 March 1988. He considered this to be adequate reason to push the proposal through. He was also concerned that the opportunity to participate in the arrangements might be lost if the Bank did not move quickly.**

4.49 If indeed there had been a belief that the Bank could have charged $110 million, or a one-year equivalent of $22 million, against the Bank's 1988 income, that belief would quickly have been set aside had professional tax advice been sought. Such advice would have included the implications of s1O4A of the Income Tax Act 1976, introduced in 1987, under which the new -accrual rules" applied to disallow the deduction of insurance premiums, other

than amounts below a nominal threshold, where those premiums relate to periods yet to expire, i.e prepaid premiums.

4.80 **In the event the Bank charged only one day's premium in its 1988 financial statements and tax accounts. If the hope of initial tax gains was a motivation for getting the arrangements in place by 31 March 1988 those hopes were not realised.**

4.SI We have been told that Budfin were not asked to give taxation advice to the Bank on manors relative to the Commission's enquiry. (see para 4.18).

4.82 **We find that the Bank did not obtain comprehensive legal or accounting advice on the taxation implications of the arrangements prior to committing itself to them. We form no opinion as to 'obvious benefits in putting the insurance cover in place and effecting the premium before 31 March".**

The Commission's findings concerning the approval process

4.83 The directors of the Bank approved the arrangements on the basis of information which was, in our view, inadequate.

4.84 In respect of the involvement of the Bank's professional advisers it is our view that the directors were misinformed by management. We are satisfied that neither the Bank's auditors nor its legal advisers were asked to advise on whether the arrangements would be effective for the purposes intended

4.88 Not only was the Board misinformed on the matter of professional advice received, but Bank management, without proper advice, failed to ascertain at the time of approval the full nature of the arrangements which were about to be entered into or the way in which they might be applied in practice.

4.56 **We are satisfied that, prior to commitment, neither the Bank's auditors nor its legal advisers were asked to give advice on whether the arrangements could be used by the Bank for the purpose of income smoothing.**

4.57 **We consider it is likely that the Bank's legal advisers did not provide a signed certificate that the deed of indemnity was in order and a proper deed to be executed by the Bank, before BNZS's seal was affixed, in accordance with the procedure routinely required by the Bank.**

4.58 **In our view someone in the Bank's senior management team should have ensured that appropriate legal and audit sign-offs had been obtained before the proposal was formally approved by the Board sub-committee.**

4.59 **We consider that the directors were entitled to believe that certificates from** both the Bank's auditors and legal advisers on both the "technical" issue of documentation and the broader issues of the use of the arrangements were being obtained.

4.60 **In our view the directors should have been formally advised of the level of fees to be paid by the Bank and been requested to give approval to them.**

4.61 **We do not think it was prudent for the Bank to consent to its firm of legal advisers also acting for the EP Group in the arrangements given the circumstances of the transaction.**

4.62 We accept the assurance given by those Bank executives and former executives, particularly McCoy, and those directors who gave evidence to .us that, at the time of entering the arrangements, there was no intention to apply the benefits under the contract against doubtful debts already identified as at 31 March 1988.

4.83 **We consider that the directors of the Bank of the day understood that income smoothing in future financial periods was to be the major purpose of the arrangements.**

4.84 We recognise that the subject matter of the arrangements would have been but one of many pressing manors engaging the attention of the directors in March 1988. In addition, the overall level of clarity of information provided to the Board for the meeting on March 17 1988 fell well short of the standard the Board was entitled to expect.

4.88 Nevertheless, the report in the agenda papers of 28 April 1988, being the report to the Board sub-committee of 30 March 1988, provided sufficient basic details of the arrangements to suggest to the more alert directors who attended the meeting that the arrangements contained unusual features. Whether or not directors recognised this in April 1988 they were well aware of the circular nature of the arrangements by October 1988 when they first came to apply them.

4.88 **The directors of the Bank in March 1988 were entitled to expect the management of the company, in which they had confidence, to act with competence and integrity. Nevertheless the arrangements were unusual and we think there may have been good reason for the directors to make further enquiry before they gave authority for the Bank to enter into them.**

5.0 CAPTIVE INSURANCE ARRANGEMENTS AND THEIR USE BY BANKS AROUND THE WORLD

General background

5.1 In paragraph 4 of his memorandum of 30 .March 1988 to the sub-committee of the Board (see paragraph 2.15 above) McCay described the proposed loan loss insurance arrangements as being on "captive insurance principles-. Before moving on to consider the Bank's use of the arrangements we briefly consider what these principles are, and whether or not it is common for banks to enter into such oontracts. We observe, however, that the arrangements in the present case do not come within the description of -oaptive insurance-.

5.2 `Captives- are so named because they are generally insurers established as subsidiaries of non-insurance companies, having, as a captive market, their owners_ insurance requirements from which to generate their business.

5.3 The arrangements were not "oaptive" in this sense. The arrangements were entered into with and premiums made over to entities outside of the BNZ group. Clack stated at p.149:

> *We said it was based on captive insurance principles. The difference is that [in the case of! most captives ... the insurer is a subsidiary of the principal company. In our case it wasn't, because we had a tax situation we avoided, a GST situation we avoided by having a third party insure it before it went through the structure. If you took away that then obviously and quite rightly as you've said it can be seen as a deposit zero coupon deposit. But the way it was structured and the accounting pn.nciples applying in those days we believed it was.*

Because, however, the description of "captive insurance" was loosely applied to these arrangements we oonsider briefly the use of captive insurance.

5.4 According to Bawcuttl, there were about 1,500 registered captive insurance companies in 1986, accounting for about 20% of worldwide industrial insurance premiums. We have seen more recent estimates putting the number of captives at around 3,000 accounting for annual cash flows of about $NZ2O billion per annum. We have not attempted to verify these figures from source **information but have no reason to dispute them.**

5.5 Captives are often established in countries which are tax havens and which have relatively relaxed laws governing the conduct of insurance business.

5.6 Industrial companies establish captive insurance companies for a number of purposes. One can be to provide economical insurance cover. A bona *fide* insurer can provide the owner with access to the reinsurance market, a market said to be character/sad by low overhead costs and fine operating margins.

5.7 **Another purpose for establishing a captive is to provide a funding mechanism to meet the owner's future, possibly cyclical, losses. Rather than the company establishing an internal sinking fund, contributions to which are not tax deductible, the company may enter into an insurance policy where the premiums payable** will **be tax deductible. This may enable the owner to bring forward the deductibility of the 'costs" of future losses.**

5.8 Captive insurance companies may be "paper" captives, generally formed in tax haven countries with the emphasis on business secrecy, relaxed regulatory supervision and low taxation, providing services solely for their owners, or may be quite substantial companies offering services to a range of affiliated companies. Bawcutt says that most captives are between these two extremes.

5.9 It is apparent that some captives are formed to provide genuine ,cost effective insurance cover for their owners. It is also apparent from the domicile of most of the captives that many are formed to provide tax advantages for their owners, with or without genuine insurance cover.

5.10 **The fact that a particular "financial reinsurance" contract (see para 5.19 for an explanation of the term) is made with a genuine captive insurance company does not mean that such a contract will necessarily meet either the legal or accounting definitions of a contract of insurance.**

The CommIssIon's survey of banks

5.11 **We asked a number of overseas owned registered banks operating in New Zealand to comment on their experience, and that of their overseas head** offices, with captive insurance arrangements.

5.12 Of the eight responses received, no bank or its parent acknowledged that it has direct knowledge or experience, either in New Zealand or elsewhere, of the use of captive insurance arrangements to cover losses from bad debts.

5.13 The head office of one bank advised us that it uses a captive insurance company, but this is in respect of non-loan losses.

5.14 The head office of another bank indicated that it was aware that certain banks used captive insurance companies to cover the risk of losses in their loan portfolios, but commented that these have proved to be tax inefficient because the transfer of insurance risk had been questioned by the relevant taxing authority.

5.15 We have seen one possible example of the use by a bank of loan loss insurance, by the major French banking group, Paribas. Paribas' 1990 Annual Report discloses that the Bank took out insurance policies in March 1990 covering a portion of its high-risk sovereign debt exposures. This may have been a captive insurance arrangement, but we have no confirmation of this.

5.16 From the admittedly limited enquiries that we have been able to make it

appears that captive debt insurance arrangements taken out by banks to cover lending risks are rare anywhere in the world, but their attempted use is not unknown.

Overseas comment

5.17 The Department of Trade and Industry (United Kingdom) made available to us a copy of the paper entitled "Financial Reinsurance' which was prepared by DTI's Insurance Division. The paper records that many financial reinsurers are spin-offs from normal reinsurers whereas others are "captive insurers". The paper then goes on to distinguish financial reinsurance conducted through "captives" which represents genuine reinsurance from financial reinsurance which does not. The paper states:

> ***Insurance Is a risk transfer mechanism whereby the insured can shift some of the uncertainty of life onto others. If there is no risk transfer there is no insurance.*** **[Original emphasis}**

The DTI paper gives a number of examples of financial reinsurance where there is no transfer of risk.

5.18 **The Division informed us that the paper had been written in response to growing concerns over the manner in which some insurance companies were structuring their financial statements to facilitate off-balance sheet diversion of insurance risk.**

5.19 E&Y provided to us through Mr Ratner a very helpful paper produced by their Australian office in April 1991 called Financial Reinsurance: A Discussion Paper. This paper described the nature and use of financial reinsurance and the emerging accounting implications. The special features of financial reinsurance are described as follows:

The following three characteristics are distinctive features of financial reinsurance..

- *The premium payable by the Insurer, and the cover provided, are am`ved at by reference to an interest rate assumption*

- *The financial outcome, or range of possible outcomes, for each party is generally documented at the outset*

- *The relnsurer's profit Is generally not dependent upon the amount of. claims arising under the contract.*

WhHe financial reinsurance contracts can strengthen the Insurer by removing volatility in Its results and bn.nglng the support of the financial reinsurer, they can also be used to disguise the true financial position of the Insurer.

In extreme cases, insurers with solvency difficulties could prevent regulators from detecting their problems and thereby delay and possibly magnify their ultimate collapse.

Financial reinsurance contracts usually have one of three purposes..

- *To recognise the time value of money*

- *to "smooth" underwriting results between years of account*

- *To provide a mechanism for funding of future claims payments.*

5.20 **The authors also deal with accounting issues arising from financial reinsurance. We will examine their comments in section 10 when we consider the appropriate accounting treatment for the arrangements.**

5.21 In dealing with the responses of the regulatory authorities the paper states:

Regulators are concerned about possible use of financial reinsurance contracts to improve the balance sheet of insurers who might otherwise have difficulty In meeting solvency requirements. Financial reinsurance contracts can distort the results of insurers to such an extent that supervisory bodies are unable to detect warning signs which would otherwise lead them to take appropriate action. In April 1991 in the UK, the Department of Trade and Industry (which supervl'ses insurers) expressed its concern that the information provided In Insurers' statutory returns was

i"nsUffiCl.enf to enable the DTI to accurately determine the impact of financial reinsurance policies.

5.22 **There has been growth evident in the captive insurance industry. We have concluded, as a result cf cur cwn enquiries and, in particular, cur discussion with the Department cf Trade and Industry, that this growth is mere likely tc arise from financial reinsurance transactions which are ncf genuine reinsurance than from transactions which are.**

PART II

THE BANK'S MARCH 1988- FINANCIAL STATEMENTS

6.0 THE ALLEGATIONS BY MR W_,._,R. PETERS M.P.

6.1 On 23 September 1992 Peters made a number of allegations in the House of Representatives concerning various parties involved in the management of the affairs of the BNZ.

6.2 Peters' principal allegations, as set out in papers tabled in the House of Representatives, so far as they relate to the present enquiry, were:

4. (That) the BNZ in 1988 provided to the New Zealand Government, the New Zealand people and to overseas institutions that provide them with funding lines a false set of accounts.

This was done by a conspiracy between:

(i) some BNZ Office Holders and Executives

ii)i) the BNZ's Auditors

iii)ii) the BNZ's Lawyers

iv)v) and Fay Richwhite

Ci) *Some of the BNZ Executors (sic) and Directors because they knew and agreed with the concealment arrangement.*

(ii) *The BNZ auditors, Ernst & Young, who the documents show gave the BNZ advice on the transaction called a "profit smooth".*

(iii) ***The Bank's lawyers, Buddie Findlay, who acted for ail parties and argent.sad the scam.***

(iv) ***Fay Richwhite who facilitated the re-insurance half of the circle***

with the use of secret Cook Island companies.

5. In March 1988 these people put Into enact [sic] a scam to permanently conceal losses of $200 million from the BNZ's books. These losses until today remained concealed because the documents show that the deal has effect until March 1993.

6. The Accounts published were fraudulent and had been relied upon by Innocent parties. The fees paid were massive and cavalier.

[Original emphasis}

Source: Papers tabled in the **House Of Representatives** on **23** September **1992.**

6.3 Later, on 7 October 1992, Peters made further allegations in the House of Representatives. In part he said:

whole arranqement is a scam.

like a valid dealL It has the appearance of a valid deal but It is facade without substance. A facade designed for the sole purpose of deceiving the marketL deceiving the minority shareholders buying BNZ sharesL deceiving the taxpayer - owner who we represent andL las!L to deceive the overseas financial markets providing credit lines to the BNZ as to the !me credit worthiness of the Bank.

[Original emphasis}

Source: Papers tabled in the House of Representatives on October 7 1992.

6.4 Peters also tabled letters and memoranda prepared within the EP group. These included a letter of 24 February 1966 from Jones, an executive of the EP group, to the Bank. Jones stated that:

We have discussed with KPMG Peat Marwlck the accounting implications of the transaction. It is our understanding that the existence of the insurance policy will enable Bank of New Zealand to receive, in respect Of the loans insured, not less than the amount provided for In the policy and thus the value of the assets insured by the policy. Notwithstanding that payment is not made until the end of the policy, as the Bank can, because

of the secun'ty outlined [above] be certain of the recovery of the principal amount it need not wn.te down the debts as doubtful debts. In KPMG Peat Marwlck's view the application of appropn.ate accounting principles will result in the accounting treatment we have discussed. We understand you w/ll have to obtain separate advice from Ernst and Whlnney on these aspects.

6.5 This advice is consistent with a memorandum to the Directors of EPBC from **Jones, dated 31 March 1988, in which it is said, at paragraphs 17.1 and 17.2:**

> *17.1* ***The insurance transaction is designed to enhance a financial institutions balance sheet. Instead of making an immediate provision In the insb.tutlons accounts for the debts the premiums are written off over the life of the policy.***
>
> ***17.2 The insurance policy that is being taken out will ensure that the BNZ Group need not show the total extent of the write off of doubtful debts In their accounts in the present financial year and thus enact their financial position. if $200 million was wt/Hen off immediately this would have a detrimental effect on BNZ's gearing ratios. Rather BNZ will accrue the premium and show it as a deduction across the five year life of the policy. This Is a profit smoothing technique.***

6.6 **On their face these letters and memoranda appeared to indicate that the Bank may have adjusted its March 1988 financial statements to conceal the existence of $200 million of bad debts and overstate its profits for that year correspondingly. The Commission determined to undertake more detailed enquiries.**

6.7 In Part I of our report we commented on the role of the Bank's legal advisers and auditors at the time the Bank entered into the arrangements. We found no evidence of conspiracy as alleged by Peters. We proceed to consider the impact of the arrangements on the BNZ's March 1988 financial statements.

7.0 THE FINANCIAL STATEMENTS OF A BANK

7.1 In order to consider whether the Bank might have modified its accounts to conceal the existence of any bad or doubtful debts it is useful to consider briefly how the financial statements of a bank are structured.

7.2 Banks lend sums of money which become assets called "loan receivables" or "advances" in the financial statements of the bank. In the ordinary course of business a bank expects to earn interest on these advances over their course and to receive the principal back at the end of the loan period.

7.3 Some loans go bad. When they do, or in expectation that they will, it is necessary for a bank to recognise this in its accounts so that the bank's income and assets are not overstated.

7.4 The first point at which banks recognise such losses is when they create "provisions for doubtful debts" in their financial statements. When a provision is created it is a direct charge against the bank's profits in that year, and the amount is deducted from the balance sheet total of the bank's loan receivables.

7.5 There are two types of provision for doubtful debts, "general" provisions and "specific" provisions.

7.6 The general provision is often likened to a reserve. Banks have general reserves as an acknowledgement that, even with the best lending practices possible, some loans will go bad. To deal with this contingency it is normal for a bank to establish and maintain, by saning aside some of its income, a -general provision for doubtful debts' in its balance sheet. This process is akin to putting something aside for a rainy day.

7.7 **There is no prescribed way for a bank to determine the amount it will put into its general provision. Practices differ between banks. They have evolved over time. A traditional practice is to put , aside and maintain a provision which is equivalent to a fixed percentage of the bank's total loan outstandings or of certain classifications of its receivables.**

7.8 **Specific provisions are created when individual loans go bad. A bank will generally realise that recovery of a particular exposure has become doubtful some time before such a loan is finally written off. The specific provision is effected in a similar manner to the general provision: a charge is made against profits for the year in the profit and loss account, and the amount of the charge is shown separately, and offset against the total of loan receivables, in the bank' balance sheet.**

7.9 **In order for a bank to present a true and fair view of its affairs it is necessary to make assessments of the extent of possible losses in its loan receivables as at its balance date or interim balance date. These assessments are inevitably subjective and can be very difficult.**

7.10 **One relevant consideration is the value of any security held by the bank. For example, if a bank has advanced $100 million to a property developer who subsequently fails, and the bank holds valid security over the developer's property, then the extent of the bank's expected loss would be measured by the amount of its exposure less the real|sable value of the property over which the Bank holds security.**

7.11 In a thin but falling property market it is difficult to obtain reliable measures of value. BNZ executives have quoted us an instance of a building originally valued by professional valuers in March 1988 at $90 million now said to be worth $IS million.

7.12 **Special difficulties can arise where a bank lends to a member of a group of companies which have engaged in a complex web of interrelated financing transactions and the group subsequently fails, possibly being put into statutory management. How does one measure the possible extent of a bank's losses? What if there are competing security claims over the same assets?**

7.13 **in all of these instances bank directors would be expected to determine the bank's likely loss on a basis which is conservative but not so conservative that the value of the bank's business becomes understated.**

7.14 Provisioning is an on-going process. in administering the normal management information systems of a bank, the credit executives will keep problem **exposures under review. As new doubts arise about a particular exposure some additional provisioning may be recommended. The board of a bank will regularly update its doubtful debt provisioning to reflect advice from management.**

7.15 **If a bank finds itself in a situation where it has to make additional specific provisions, it may be possible to make a corresponding reduction to the level of its general provision. if the bank follows this course there would be a nil impact on the bank's profit in that year because the general provision had been created by charges against the profits of earlier years. This course will only be appropriate if the bank's general provision remains adequate after the transfer to specific provisions has been made.**

7.16 It is worth noting that the timing of the actual write-off of a bad debt for which specific provisioning has previously been made is largely irrelevant to the determination of a bank's annual profitability. When a debt is written off it is **against the specific provision which was previously created with respect to that particular debt.**

7.17 It is because banks have the capacity to set aside profits into their general provisions in good years, and draw on them in poorer years, that doubtful debt provisioning is sometimes regarded as giving the opportunity for prof&-smoothing.

7.18 Although the form of profit-smoothing referred to above [which was also referred to by Lojkine in her evidence (see para 4.36) has the capacity to misinform, by departing from the true and fair view required of financial statements, the approach which postpones recognition of profit is far less objectionable than the approach which accelerates recognition of income. This view accords with the fourth of the four .important criteria` established by paragraph 4.6 of SSAP-1 (see para 10.9 for further discussion of these criteria) for selecting the most appropriate particular accounting policy from the range of alternatives:

> ***Prudence***
>
> ***The uncertainties which surround many business transactions should be recognised by the application of prudence in the selection of the particular accounting policies to be used.*** **[Original emphasis}**

8.0 **THE BANK'S MARCH 1988 FINANCIAL STATEMENTS**

The financial statements

8.1 In the financial statements for the year ended 31 March 1988 the Bank recorded an Operating Profit before Provisions and Tax of $461 million (compared to $335 million the previous year), charged $206 million against income to increase general and specific provisions for doubtful debts (compared to $63 million the previous year) and produced an Operating Profit before Tax of $255 million ($271 million in 1987).

8.2 **Of** the $206 million charged against profits to increase provisions for doubtful debts, $35 million was for the purpose of increasing the Bank's general provision for doubtful debts, which at 31 March 1988 stood at $129 million, or 0.94% of the Bank's total advances of $13.7 billion. (The equivalent level at 31 March 1987 was $94 million, or O.85o/o of total advances of $11.0 billion.) The remainder of the charge against profits, $171 million, increased the Bank's specific provisions for doubtful debts.

8.3 **In 1988 the Bank also wrote off bad debts, net of recoveries, of $160 million, compared to net write-offs the previous year of $24 million. The timing of these write-offs did not affect the Bank's profit, as provision had already been made for these bad debts. However the timing of the write-off would have been material for taxation purposes.**

Our review of the Bank's March 1988 financial statements

Procedure

8.4 For the purpose of satisfying ourselves as to the Bank's 1988 financial statements we reviewed all material considered by the Board relative to provisioning from September 1987. We have also reviewed all the audit work papers of E & Y (initially Ernst & Whinney and BOO) relating to the Bank's provisioning from September 1987.

8.5 We have examined this material closely. We have questioned various persons who were executives or directors of the Bank at the relevant time.

The Bank 's specific provisioning

8.6 **The Board papers disclose that management had identified a need for total specific provisions as at 31 December 1987 of $124 million. By the end of**

January 1988 (based on papers considered by the directors on 17 March 1988, the same meeting at which directors first become aware of the proposed insurance arrangements) this requirement for specific provisions had increased to $186 million. At their meeting of 28 April 1988 the directors considered recommendations from management to increase specific provisions at 31 March 1988 to a net $204 million (before write-offs).

8.7 **At the meeting of the Board on 19 May 1988, at which the Bank's March 1988 accounts were approved, directors considered management recommendations to increase specific provisions to a level, before write-offs, of $215 million. This would have required a charge against profits of $163 million. In the event the charge made against profits in the financial statements for additional specific provisions was $171 million, which, when added to the Bank's opening level of specific provisions of $55** million, **totals $226 million.**

8.8 **One of the Bank's largest provisioned accounts was its exposure to Judge Corporation which at 31 March 1988 was $111 million. The Bank provided (and wrote off) $50 million against that exposure in its financial statements, with the balance being covered by the value of a block of Ariadne shares over which the Bank held security.**

8.9 **It is apparent that the Bank continued to increase its specific provisioning requirements both prior to the commencement of negotiations with EP, during the process of approving the arrangements, and after the arrangements were put in place.**

8.10 There is no indication in the papers that the existence of the arrangements influenced the specific provisioning process at 31 March 1988.

The Bank's general provision

8.11 **The Bank increased its general provision at 31 March 1988 by $35 million to a figure of $129.4 million. The Bank did not use any of its existing general provision to fund its increased specific provisions.**

8.12 We found no evidence in the papers that the arrangements had influenced the level of the Bank's general provision at 31 March 1988.

Evidence of witnesses

8.13 **McCay, Diack and Tennent, in their evidence to us, vigorously denied that the existence of the arrangements had any bearing on the level of the Bank's general or specific provisioning at 31 March 1988.**

8.14 **It 18 apparent from the evidence of these executives that the Bank was going through a very stressful period at the time. There had been the sharemarket crash in October 1987 and they did not know how deep or prolonged the effects would be. There were uncertainties in the property market although it still appeared to many to be reasonably firm. The Bank recognised that it could have problems with some of its corporate exposures and was moving to try and improve its security position and otherwise to address the matter through appropriate provisioning.**

8.15 Several Bank directors gave evidence on this issue. Lojkine said at p.967:

> ***I assure you that my recollection of the time there was no linkage between entering into this arrangement and the current provisioning. ... I can 't recall any hint of concern about the /eve/ of provisioning or concern about the profit.***

8.18 Lojkine said that her expectation, based on advice from Bank management, was that the Bank would be profitable in both 1988 and 1989. She expected that the arrangements would be used to put profits aside (by charging premiums against income and not making any claims) in the early years to provide a form of reserve to meet possible losses occurring some years away.

8.17 Bayliss, asked if the arrangements influenced 1988 provisioning, said at p.919:

> *... I think that we [the directors} forced up [the /eve/ of provlslonlng]. I think there was quite an argument at the Board and I think the provisioning was quite significantly increased. It was the first time there was an absolutely very strong difference of opinion between the Board and the executive...*

Audit work papers

8.18 The audit work papers give no indication of any under-provisioning in the Bank's 1988 accounts.

8.19 It is normal procedure for auditors to form their own view of a bank's provisioning requirement and to compare this with the recommendations made by the bank. Gerty said in evidence that in performing this task at the BNZ he was not influenced by, and the arrangements made no difference to, the level of the Bank's provisioning at 31 March 1988 or to the way the auditors viewed

8.20 The auditors' management !suers to the Bank during this period indicate some concerns about the procedures the Bank was using to ensure a close watch was kept on non-performing accounts. These concerns may help to explain why the Bank significantly increased its level of doubtful debt provisioning in later periods, but they do not indicate any possible or planned use of the arrangements at 31 March 1988.

Our flffdlnge relating to the Bank'e March 1988 financial etatementa_

8.21 We find that the only influence the arrangements had on the Bank's 31 March 1988 financial statements was with respect to the charge against profits of $62,000 and the substitution of a pro-paid expense asset of $110 million for an investment asset of like amount. Given the size of the Bank and its profitability for the year, neither of these influences was material and in our view there was no requirement for the Bank to disclose them.

8.22 We find that the directors of the Bank did not use the existence of the arrangements to understate the level of the charges against profits for either general or specific provisioning for doubtful debts in the Bank's financial statements for the year ended 31 March 1988.

8.23 We have no reason to believe that the financial statements of the Bank for the year ended 31 March 1988 did not present a true and fair view of the financial affairs of the BNZ at that time.

8.24 While it is easy to argue with hindsight, particularly given the Bank's losses in 1989, that the Bank should have made even larger doubtful debt provisions in 1988, we do not think the need for this increased provisioning was evident to directors at the time. The Bank's actions must be seen in the light of the circumstances and knowledge of that time.

8.25 We found no evidence that BNZ published a false set of accounts for the year ended 31 March 1988 as alleged by Peters.

PART IIf

LEGAL AND ACCOUNTING ISSUES RELATING TO THE BANK'S USE OF THE ARRANGEMENTS FROM SEPTEMBER 1988 UNTIL'SEPTEMBER 1992

9.0 LEGAL RESPONSIBILITIES IN RELATION TO THE TRUTH AND FAIRNESS OF COMPANY ACCOUNTS

Introduction

9.1 **In section 3 we examined the question whether the arrangements ware s genuine insurance contract at law. That assessment contained a review of the legal form. In this section we review the legal responsibilities of directors and auditors in relation to the preparation of the financial statements of a reporting entity in terms of the Companies Act 1955 and the Securities Act 1978. In the succeeding sections of this Part we explore further the requirement that financial statements present a "true and fair" view and outline a framework for determining how the accounting treatment for any particular transaction should be arrived at.**

The reeponalbilltlea of directore

9.2 **Directors have a statutory responsibility to present the accounts of the company before shareholders in accordance with the provisions of the Companies Act and have a further responsibility under the Securities Act,in relation to accounts which are contained in any prospectus.**

9.7 Section 159(1) Companies Act 1955 provides -

> ***Every balance sheet of a company shall be signed on behalf of the Board by two of the directors of the company.***

9.8 Section 41(b)(i) Securities Act requires every prospectus delivered to the Registrar for registration under that Act to be signed by every person who is a director of the issuer at the time the prospectus is delivered to the Registrar, or by its or his agent authorised in writing.

9.9 **\t is apparent from these provisions that the obligation to present accounts to shareholders which comply with the truth and fairness requirement of the Companies Act, and the obligation to include in a registered prospectus & balance sheet and profit and loss account which comply with the truth and fairness requirement, are obligations which these statutes place on the directors.**

9.10 A director must bring his or her individual judgment to bear on matters which are brought before the director in the exercise of his or her responsibilities, in particular, on financial statements presented to the Board at board meetings which the director has attended. In the leading case of Dovey v. Cory [1901] AC 475, 492 Lord Davey stated -

> ***I think the respondent was bound to give his attention to and exercise his judgment as a man of business on the manors which were brought before the Board at the meetings which he attended ....***

In Jaqwar Holdings Ltd v. Julian (1992) 6 NZCLC 68040, 68075 Thorp J summarises the responsibility of a director in this respect in the following words

> ***... While directors have only limited obligations to search out information, they have always been required to pay attention and give appropriate consideration to material placed before them.' see e.g Land Credit Company of Ireland v. Lord Former (1870) LR 5 Ch App 763 at p.770,***

9.3 Section 183(1) Companies Act 1988 provides -

> ***Every balance sheet of a company shall give a true and fair view of the state of affairs of the company as at the end of its financial year, and every profit and loss account of a company shall give a true and fair view of the profit or loss of the company for the financial year.***

Sub-sections (2) and (3) of this section make it clear that the requirement that the company's accounts are to comply with the requirements of the Eighth Schedule is subject to the over-riding requirement of the truth and fairness in sub-section (1).

9.4 Section 166(1) sets out a similar obligation in relation to group accounts -

> *The group accounts laid before a company shall give a true and fair view of the state of affairs and profit or loss of the company and the subsidiaries dealt with thereby as a whole, so far as concerns members of the company.*

Sub-section (3) again makes it clear that the obligation to comply with the Eighth Schedule is subject to the over-riding obligation of truth and fairness.

9.5 **Clause 16, Second Schedule, Securities Regulations 1983, provides that a debt prospectus is to contain -**

> ***an audited consolidated balance sheet of the group giving a true and fair view of the state of affairs of the group -***
>
> ***(a) As at the end of the most recently completed accounting period thereof; ...***

9.6 Clause 27(1) requires the prospectus to contain -

> *An audited consolidated profit and loss account of the group giving a true*
>
> *(a) For the most recently completed accounting period of the ...*

where Lord Ha/barley declared it was /he duty of directors "to be awake, and /heir being asleep would no/ exempt /hem from /he consequences of no/ attending to /he business of /ha company.

9.11 **Where directors are required to certify to a particular state of affairs, such as the state of a company's accounts, each of them is bound to exercise an individual judgment on those accounts and cannot delegate that responsibility to some part only of the Board, or to other persons. In Delcine Haskins & Sells v. National Mutual Life Nominees (1991) S NZCLC 67418, 67427 the Court of Appeal affirmed the judgment of Henry J who had held that each director on the Board had a responsibility to ensure that quarterly reports made to trustees for debentureholders on the financial position of the company were true and correct. That responsibility was held to extend to a director who had not signed the relevant report and was absent from the meeting at which it was considered. The Court observed that the report was required by the debenture trust deed to be signed by two directors on behalf of the Board, and accordingly the Board as a whole had responsibility to give the matter their attention. Similar considerations apply to a company's balance sheet and profit and loss account which the statute require are to be signed by two directors -on behalf of the Board", and, in the case of a company prospectus, the prospectus is required to be signed by every director or his or her authorised agent.**

True and Fair View

9.12 **In determining whether the accounts present a true and fair view as required respectively by the Companies Act and the Securities Regulations for the purposes of those respective statutory provisions, regard must be had to statements of accounting practice. In Lloyd Cheyham & Co. Ltd v. Little}ohn & C[1987] BCLC 303 the Court considered whether defendant directors in that case were entitled to rely on statements of standard accounting practice issued by the Institute of Chartered Accountants of England and Wales ("ICAEW").**

The Court stated at p.313 -

> ***As to the proper treatment of such statements, the approach of both counsel was the same and I accept this approach. While they are not conclusive, so that a departure from their terms necessarily involves a breach of the duty of care, and they are not as the explanatory foreword makes clear, n.gid rules, they are very strong evidence as to what is the proper standard which should be adopted and unless there is some justification, a departure from this will be regarded as constituting a breach of duty. It appears to me important that this should be the position because third parties in reading the accounts are entitled to assume that they have been drawn up in accordance with the approved practice unless there is some indication in the accounts which clearly state that this is not the case.***

9.13 **This was a case concerned with the application of SSAPs but the principle stated is equally applicable to generally accepted accounting practices (GAAP) when there is no SSAP on the manor in issue. The relevant principles are helpfully discussed by McGee in an article The True and Fair View Debate: A Study in the Legal Regulation of Accounting- (1991) 54 Mod. L. Rev 874.**

9.14 SSAPs and GAAP must be read subject to the overriding requirement of truth and fairness. As stated by Vinelott J. in Prudential Insurance Co v Newmans Industries (No. 2) [1980] 2 All ER 841, 850:

> ***The Institute of Chartered Accountants from time to time issues Statements of Standard Accounting Practice which prescribe methods of accounting approved by the Council of the Insb.lute. The Standards prescribed are not intended to be a comprehensive code of Inflexible mies but they are intended as more than a guide or indicator of practice. Where, for some exceptional reason, they are impractical or inappropriate a departure from the Standards must be disclosed and explained. They must of course be read subject to the overriding requirement that accounts must be so presented as to give a true and fair view of a company's affairs.***

9.15 The Commission in its Report on Capital Structure and Financial Reporting in New Zealand, December 1989, paras 4.7 to 4.10 referred to two approaches to -true and fair-:

(a) an overview approach giving the words their ordinary and popular meaning,

(b) a financial approach, giving the words an interpretation as a term of accounting, i.e. in accordance with accounting principles recognised by authoritative accounting bodies or best accounting practice.

9.16 The Commission rejected the technical approach and considered the overview approach should prevail:

> ***Our opinion is that the "technical- approach ,should be rejected and the "overvl'ew- approach should prevail. The question whether a given set of financial statements presents a true and fair view should be treated as a question of fact In each case. On that basis, compliance with legal requirements and accounting standards is requisite, but not necessarily sufficient, to present a true and fair view. A true and fair view requires that the financial statements be prepared, not by a mechanical process applying the accounting standards and regulatory requirements, but with the exercise of judgment to ensure that the presentation is appropriate, consistent and comparable and that weight is given to the reasonable expectations of the users.of genera/purpose financial statements. In other words, it seems to us that authors of financial statements, having complied with the /aw and the SSAPs, should stand back from the result and consider whether or not further information should be included in the statements to present a true and fair view.***

9.17 This ."overview approach- was also taken in an influential legal opinion provided to **the** Accounting Standards Committee of the Institute of Chartered Accountants of England and Wales and published in Accountancy, November 1983 (pp 154-156), and cited in The Accountants_ Journal, February 1984 (pp 18-19). The opinion given was that the question whether accounts give a true and fair view is a question of law to be determined by the Court, having as s guide the ordinary practices of professional accountants and in particular SSAPs, but depending finally on the Court's view of whether -the information contained is sufficient in quantity and qualify to satisfy the reasonable expectations of the readers to whom they are addressed-. These expectations include what the readership of the accounts (which will consist of businessmen,

investors and bankers as well as professional accountants) all expect to find there, with those expectations moulded by the practices of professional accountants.

The role of the auditor in,, relation to directors'. responsibilities

9.18 **The present facts raise a further issue of some importance. To what extent, in having regard to statements of standard accounting practice, or to the application of generally accepted accounting practice, is a director able to defer to the judgment of the company's auditor as a person having particular professional expertise and competence in making judgments of that kind? Little guidance is given in the cases which have come before the Courts as almost all of the reported decisions concern failure on the part of directors (and auditors) to detect defalcation or errors in the compilation of the company's accounts made by employees of a company. Clearly directors have an independent responsibility when it comes to the detection of fraud or the maintenance of adequate internal accounting systems. The directors may rely on trusted employees and auditors to carry out their respective responsibilities in administering and checking internal financial systems. The cases have also dealt with the responsibility of directors when facing business risks and incurring expenditure. It is in contexts of that kind that the Courts have stated that a director is not liable for mere errors of judgement and is entitled to rely on the judgment, information and advice of apparently competent management or professional advisers. Again in Dovey v. Cory (supra.) Lord Halsbury LC stated at p.486 -**

> *The argument raises a serious question as to the responsibility of all persons holding positions like that of directors, how far they are called upon to distrust and be on their guard against the possibility of fraud being committed by their subordinates of every degree. It is obvious if there is such a duty it must render anything like an intelligent devolution of !about impossible. Was Mr Cory to tum himself into an auditor, and managing director, chairman, and find out whether auditors, managing directors and chairmen were a!l like deceiving him? That the !odors of the auditors were kept from him is clear. But he was assured that provision had been made*

> ***for bad debts, and that he believed such assurances, is Involved in the admission that he was guilty of no moral fraud; so that it comes to this, that he ought to have discovered a network of conspiracy and fraud by which he was surrounded and found out that his own brother and the managing director (who have since been made criminally responsible for frauds connected with their respective offices) were Inducing him to make representations as to the prospects of the concern and the dividends properly payable which have turned out to be improper and false. I cannot think that it can be expected of a director that he should be watching either the inferior officers of the Bank or ven.fy any calculations of the auditors himself. The business of life could not go on if people could not trust those who are put into a position of trust for,the express purpose of attending to details of management.***

At p.492 Lord Davey states -

> ***/ think the respondent was bound to give his attention to and exercise his judgment as a man of business on the matters which were brought before the Board at the meetings which he attended and it Is not proved that he did not do so. But I think he is entitled to rely upon the judgment, information, and advice of the chairman and genera/ manager, as to whose integn.ty, ski// and competence he had no reason for suspicion. I agree with what was said by Sir George Jesse/ in Hallmark's case (1878) 9 ChD 329 and by Chi.tty J In re Denham & Co. (1883) 25 ChD 752 that directors are not bound to examine entries in the company's books. It Is the duty of the genera/ manager and (possibly) of the chairman to go carefully through the returns from the branches, and to bring before the Board any matter requiring their consideration; but the respondent was not, In my opinion, guHty of negligence in not examining them for himself, notwithstanding that they were laid on the table of the Board for reference.***

Similarly, in re City Equitable Fire Insurance Co. Ltd [1990] Ch. 407 Romer J held that a director who acts honestly is not liable for mere errors of judgment, and that in the absence of grounds of suspicion a director is justified in trusting officials of the company to perform their duties honestly. The same approach was taken recently by Gallon J. in New Zealand in Gurn v Laing [1991] 1 NZLR 482.

9.19 It is in the context of those statements of principle that the observations of Rogers CJ in the recent decision of the New South Wales Supreme Court in AWA Ltd v. Daniells (1992) 10 ACLC 933 must be understood. At p.1015

Rogers CJ states -

> In *relation to auditors, If directors appoint a person of good repute and competence to audit the accounts,* ***absent*** *real grounds far suspecting that the auditor is wrong, the directOrs will* ***have discharged*** *their duty to the Corporation. The directors are not required to /Oak* ***at the*** *entries in any of* ***the*** *Corporation's* ***bOOks*** *of record, or verify the calculatiOns of the* ***COlporatlOn's accountants*** *In prepan`ng the financial statements or of the mud/tar himself. Directors are entitled to rely on the judgment, InfOrmatiOn and* ***advice*** *of the auditor (Cf.* <u>*In re Bonham & Co.*</u> ***(1883) 25 ChD 752, 766; Dove~ v.*** <u>*Cory*</u> *(supra)* ***488, 492.)*** *Reliance may properly* ***be*** *more* ***cOmplete where the*** *auditor* ***ls acknowledged as being*** *more* ***knOw/edgeab/e,*** *skilled and experienced In the particular matter In question than the directors or other auditors. A director Is* ***ant/Bed*** *to expect the auditor to carry out* ***/ts duties*** *utllls/ng that higher* ***degree*** *of* ***knOw/edge,*** *skill and experience. In such circumstances the auditor will* ***be*** *under a higher duty of* ***care*** *than the standard of* ***care*** *of an auditor withOut such specialist* ***knOw/edge,*** *skill and experience.* <u>*(In re ThOmas Gerrard & San Ltd*</u> ***[1968]*** *Ch* ***455, 575,' Pacific Acce*** *ta rnco rat/On v.* <u>*FOrsyth*</u> ***(1970) 92 WN*** *(NSW) 29,* ***74,' Hgig v.*** <u>***BamfOrd***</u> ***(1977)*** *72 DLR (3RD)* ***68, 74,'*** <u>*Bartlett*</u> *v.* <u>*Barclay& Trust Co. Ltd*</u> ***[1980]*** *1 Ch* ***515, 534).*** *In the present* ***case, Daniel/s was a*** *partner In one of* ***the big*** *six major International accounting firms. The* ***directOrs were*** *entitled* ***tO*** *rely On the* ***belief*** *that he cOuld* ***draw*** *on all the resources of such a firm.* ***Indeed,*** *If the truth* ***be*** *known, to a large extent It* ***was*** *nOt lack of* ***knOw/edge*** *of* ***facts that*** *inhibited the proper discharge* ***by*** *Danie/ls of his duties.*

This was a case where serious accounting irregularities were revealed in the foreign exchange operation run by AWA Ltd. It was in relation to their failure to detect these irregularities that the directors were held to be entitled to rely on the expertise and professional judgment of the company's auditors.

9.20

That is not the issue in the present case. We are not here concerned with any alleged failure on the part of the Board to detect fraud or irregularities in the records or internal accounting controls conducted by the Bank. The issue with which we are concerned is whether the accounts of the Bank as placed before **the shareholders in general meeting and released to the market, and the accounts as set out in prospectuses issued by the Bank, presented the financial position of the Bank with truth and fairness as required by the provisions of the**

directors are, in accordance with the cases referred to in the preceding paragraphs 9.18 and 9.19, required to exercise their judgment as a Board. In doing so they are entitled to have regard to expert assistance and advice of professional auditors, but they are not able to delegate to the auditors the function which they have as directors under the Companies Act and the Securities Act. In that respect we note the increasing reluctance on the part of the Courts to permit directors to shelter behind a delegation of responsibility. As stated by Thorp J in Jaqwar Holdings Ltd v. Julian (supra.) at p.8075 -

> ***... Such decisions as Hilton International Ltd {In Liq } v. Hilton [f 9891 1 NZLR 442 and the dissenting judgment Of Kirby P In Meta/ Manufactures Pty Ltd v. Lewis (1988) 13 NSWLR 315 are evidence Of a growing desire to limit director's ability to -wash their hands- of any obligation to maintain an intelligent oversight Of the company's affairs.***

9.21 It is also important to observe that the Board of the Bank appointed an audit committee with special responsibility to examine auditing issues and confer with the auditors and report to the Board. The application of appropriate accounting standards and judgments on the truth and fairness of the accounts and issues of materiality in relation to appropriate disclosure were examined by that committee and were the subject of report to the Board. The Board was required to make its own judgment on these matters, aided by the professional advice of the auditors, and the Board did so. With respect to the Bank's financial statements for the year ended 31 March 1990 the minutes of the Bank's meeting of directors of 21 May 1990 records that Sadler, chairman of the audit committee, advised the Board:

> ***In respect of the need for directors to take a True and Pair view of the accounting position of the Bank, Mr Sadler reviewed the differences between the USA and UK/Commonwealth interpretations, and concluded that the legal view in New Zea/and is to stand back from the mechanistic line by line approach to provide an overall True and Fair view. Mr Sad/er also noted that the accounts are those of the directors,- and the directors cannot therefore stand behind the auditors. Further there is a need to raise standards of disclosure from companies across the whole market, and less than full disclosure was seen to be intolerable.***

The responsIbIlIties of auditors

9.22 **Like the directors, the auditors have certain statutory responsibilities under the Companies Act and the Securities Act in relation to the truth and fairness of the company's accounts. Under 8.166(1)(c) of the Companies Act the auditors are required to make a report to shareholders on the accounts examined by them, and on every balance sheet, every profit and loss account and all group accounts laid before the company in general meeting during their tenure of office, and the report is to state, inter alls -**

> ***(c) Whether,*** *In* ***their opinion, according to the best of their Information and the explanations given to them and as shown by the books of the company, -***
>
> ***(i) The balance sheet Is properly drawn up so as to give a true and fair view of the state of the company's affairs at the end of its financial year; and***
>
> ***(ii) The profit and loss account is properly drawn up so as to give a true and fair view of the results of the business*** *of* ***the company for Its financial year, -***
>
> ***or, as the case may be, so as to give a true and fair view thereof subject to the non-disclosure of any matters (to be Indicated*** *In* ***the report) which by virtue of Pad III of the Eighth Schedule to this Act are not required to be disclosed.***

9.23 **In relation to a debt prospectus, clause 36 Second Schedule Securities Regulations 1983 provides that the prospectus must contain -**

> *A copy of a report by a qualified auditor, signed by him (either in his own name or that of his flrm), stating -*
>
> *(a)* ***Whether or not, In his opinion, the financial statements that are required by clauses 16 to 31 of this Schedule and that are required to be audited comply with these Regulations and In accordance therewith give a true and fair view of the state of affairs of the group as at the date thereof and of the results and cashflows of the group for the pen.ad to which they relate,' and***

(b) ***Whether the amounts stated pursuant to clauses 7(2), 7(3), 8(2), 8(3) and 12 of this Schedule have been taken from audited financial statements, and whether or not the amounts have been correctly taken.***

9.24 **The relevance of statements of standard accounting practice and generally accepted accounting principles in determining whether the accounts present a true and fair view has been considered at paragraphs 9.12 to 9.14 above.**

9.25 **The standard of care to be exercised by an auditor in carrying out his or her responsibilities are aptly stated by Henry J in National Mutual Life Nominees d v. Worn (1990) 5 NZCLC 66384, 66420 -**

> ***The standard of care required by an auditor In the performance of his professional duties Is well-established. It is to exercise the skill and the care properly expected of a reasonable and prudent auditor carrying out the tasks in question. The classic statement Is that of Lopes LJ In Re Kingston Cotton Mill Co. {No.2) [1896] 2 Ch 279 at pp.288-289._ -It is the duty of an auditor to bring to bear on the work he has to perform that skill, care and caution which a reasonably competent, careful and cautious auditor would use. What Is reasonable skill, care and caution must depend on the particular circumstances of each case. ...-. The nature of the legal duty has not altered, although of course the reasonableness and skill to be exercised must meet the changed conditions of today. Evidence as to the genera! practice of auditors Is relevant, although It must be borne In mind the ultimate decision in any particular case must be for the Court. Evidence of general practice Is valuable but not necessarily determinative***

That statement found support in the Court of Appeal in Deloitte Haskins & Sells v. National Mutual Life Nominees (1991) 5 NZCLC 67418, 67431.

9.26 The auditors in approaching their task must do so in accordance with recognised and explicit professional standards and regard must be had in this context to statements of auditing practice issued by the New Zealand Society of Accountants. This was recognised by the Court of Appeal in Deloitte Haskins & Sells v. National Mutual Life Nominees (supra.) at p.67432 where Casey J stated -

> ***These principles afford special protection to auditors, whose task Is not to draw the accounts nor to tum every stone and open every cupboard but to exercise their very considerable skill and judgment in carrying out checks and investigations in accordance with complex but nonetheless detailed and explicit professional standards.***

9.27 **Many entries in the accounts** will **depend on the exercise of the directors' judgment for example, matters such as the adequacy of provisions for doubtful debts and questions of materiality in relation to disclosure. In those respects the auditors' function is to satisfy themselves, not that the judgment is correct, but that it is reasonable. At p.67432 Casey J repeats observations that were earlier made by the Court of Appeal** in **England** in **Caparo Industries plc v. Dickman [1989] 1** All **ER 798, 811 -**

> ***Many entn'es in the accounts will depend on the directors' judgment and here it is for the auditors not to satisfy themselves that the judgment is correct but that It is reasonable. Lord Hallsham LC said in Re W{an infant} [1971] 2 All ER 49 at 56, [1971] AC 682 at 700:***
>
>> ***"Two reasonable parents can perfectly reasonably come to opposite conclusions on the same set of facts without forfeiting their title to be regarded as reasonable ... Not every reasonable exercise Of judgment is nght, and not every mistake in exercise of judgment is unreasonab!e.".***

It is important to take those observations into account when examining the approach taken by the auditors in the present case. On matters of judgment, where views may legitimately differ, the auditor's function is to determine whether the directors' judgment on those matters is reasonable, and it **is for the auditors to be satisfied** in **that respect.**

10.0 THE APPROPRIATE ACCOUNTING TREATMENT FOR THE ARRANGEMENTS

A framework for determining the appropriate accounting treatment for the arrangemente

10.1 In section 9 we outlined the legal requirements that accounts should present a true and fair view of the state of affairs and results of a particular entity. We now consider how this requirement should be interpreted in practice.

The reou/rements for presentation of a True and Fair view

10.2 Professor D.G. Trow, who appeared as an expert witness for the Bank, In a speech to an IIR conference on 14 June 1988 entitled Presentation of a True and Fr ,View subtitled How far can you go whilst complying with the accounting standards provides useful guidance. He states:

> ***The statutory requirement is designed to ensure that part/es outside the company administration, especially shareholders and creditors, are informed on the financial position and results of operations of the enterprise.***
>
> ***These parties are entitled to be fully informed on the company's circumstances. As a consequence I find appeal in the following explanation of a true and fair view as set down in the recent technical series re/ease 603 from the Institute of Chartered Accountants in England and Wales ("ICAEW").-***
>
> > *A true and fair view implies the provision of sufficient information, properly displayed, to enable the user to assess the performance of the business, the full extent of /ts assets and liabilities and /ts risk exposures.*
>
> ***When it comes to the technical requirements to meet the qualitative standard I find it best to refer to the prescription of New Zealand Auditing Guideline No 2 which states..***

> *A true and fair view implies disclosure and appropriate classification and grouping of all material items and consistent application of acceptable accounting principles. Conformity with acceptable accounting pn.nciples implies (i) compliance with SSAPs and (ii) that any accounting policies not covered by SSAPs are appropn.ate to the circumstances of the entity and have substantial authoritative support.*

This still leaves the question - what is it that constitutes "substantial authoritative support"? The use of a particular procedure by another company does not in itself constitute substantial authoritative support. If a circumstance is not covered by a NewZea/and Standard this support would be found in standards of overseas countries in, I suggest, the following descending order of importance:

/ASC, UK, Australia, Canada, USA

Other sources of support would be exposure drafts from these tern.tori.es, and leading text books.

If a proposed procedure cannot be supported by reference to these authoritative sources then I would suggest it is most unlikely that the use of the procedure on the New Zea/and scene can be justified.

10.3 **We have found this outline useful, although as we shall see later we received oontradictory advice concerning the significance of American aooounting standards.**

10.4 **In looking at the accounting treatment of any particular transaction (assuming for the moment that it is suffioiently large to have a "material" influenoe on the results of the entity) we consider it is necessary to ask the following questions:**

1)does the treatment comply with current SSAPs?

2) if the treatment being used/proposed is not covered by current SSAPs, are the accounting policies:

(i) appropriate to the circumstances of the entity; and

ii)i) do they have substantial authoritative support; and

iii) ii) are they in accordance with the entity's own general accounting policies.

10.5

Later in this section we will apply these criteria to the arrangements to determine what we consider is the appropriate accounting treatment for the arrangements looked at at the present time.

The requirements of current SSAPs

10.6

There has not been a specific New Zealand statement of standard accounting practice which deals with the manner in which the arrangements were treated. However there has been general guidance available throughout the period.

10.7

SSAP 1 *Determination and Disclosure of Accounting Policies,* first issued in November 1975 and revised in December 1983, provides guidance on the choice of an entity's general accounting policies. Para 4.2(b) of the Statement says:

> ***Matching** of **Expenses and Revenues.** Under accrual accounting, expenses and revenues are recognised as they are Incurred or earned (rather than as money is paid or received) and recorded in the financial statements of the period to which they relate. Results for the period are determined by matching expenses with the related revenues.*

10.8

The Bank states, when nominating its "General Accounting Policies- in its published financial statements,

> *Accrual accounting is used to match expenses and revenues.*

This policy is commonly referred to as the "matching principle.. It is consistent

10.9 **Where the New Zealand chartered accountant is unable to find a directly relevant New Zealand accounting standard SSAP-1 lays down guidance for the selection of appropriate particular accounting policies. It says:**

> ***4.8 Certain important criteria should be considered in selecting the most appropriate particular accounting policy from the range of alternatives -***
>
> *(,a)* ***Substance over form.*** *Transacb.ons and other events should be accounted for and presented in accordance with their substance, that Is their financial and economic reality, and not necessarily In accordance with their legal form.*
>
> ***b) Relevance Financial statements should provide users with information which may assist in making evaluations or decisions.***
>
> *(c)* ***Consistency. Pad/cu/or*** *accounting policies adopted by an entity should normally be consistent from one period to another, and should be applied to all items of a similar nature. However, consistency, in itself, should not be used as an argument for the retention of a* ***pad/cu/or*** *accounting policy which Is no longer appropriate.*
>
> *d) Prudence. The uncertainties which surround many business transactions should be recognised by the application of prudence In the selection of the pad/cu/or accounting policies to be used.*

10.10 In terms of the SSAP-1 guidance we need to look at any accounting treatment and ask:

a) did it follow the Bank's general accounting policy and properly match expenses to revenues?

b)did it recognise the economic substance of the arrangements?

c) was the treatment relevant to the circumstances of the Bank?

d) was the treatment consistent with that for previous periods, noting that consistency should not be used to justify continued application

d)

of inappropriate accounting treatment? and

(e) was the treatment prudent?

10.11 **Having reviewed the actual or proposed treatment for the arrangements in terms of the guidance of SSAP-1 we then need to consider, in terms of Auditing Guideline 2 referred to by Trow, whether there was any substantial authoritative support for the particular treatment chosen.**

The "substantial authoritative support"

10.12 **The Financial Accounting Standards Board of the United States (-FAST) issued its Statement of Financial Accounting Standards No.5, Accountinq for Contingencies, in March 1975. In an appendix to the statement, saning out examples of the application of the standard, it says:**

Payments to Insurance- Companies That May Not Involve Transfer of Risk

> ***44.To the extent that an insurance contract or reinsurance contract does not, despite its form, provide for indemnification of the insured or the ceding company by the insurer or reinsurer against loss or liability, the premium paid less the amount of the premium to be retained by the insurer or reinsurer shall be accounted for as a deposit by the insured or the ceding company. Those contracts may be structured in various ways, but if, regardless of form, their substance is that all or part of the premium paid by the insured or the ceding company is a deposit, it shall be accounted for as a deposit.***
>
> ***45. Operations in certain industries may be subject to such high risks that insurance Is unavailable or is available only at what is considered to be a prohibitively high cost. Some enterprises in those industries have "pooled" their risks by forming a mutual insurance company in which they retain an equity interest and to which they pay insurance premiums. For example, some electric utility companies have formed such a mutual insurance company to insure n'sks related to unclear power plants, and some oil companies have formed a company to insure against risks***

associated w/thpetroleum exploration and product/on. Whether /he premium paid represents a payment for the transfer of risk or whether it represents merely a deposit will depend on the circumstances surrounding the enterprise's interest in and insurance arrangement with the mutual company. An analysis of the contract is required to determine whether risk has boon transferred and to what extent.

10.13 **The FASB issued its Statement of Financial Accounting Standards No 97 Accountinq and Reportinq by Insurance Enterprises for Certain Lonq-Duration Contracts and for Realized Gains and Losses from the Sale of Investments in December 1987. Section 15 of the Standard says:**

Investment Contracts

15. Investment contracts issued by an insurance enterprise, as defined in this Statement, do not incorporate significant insurance risk as that concept is contemplated in Statement 60 and shall not be accounted for as insurance contracts. Amounts received as payments for such contracts shall not be reported as revenues. Payments received by the insurance enterpn.se shall be reported as liabilities and accounted for in a manner consistent with the accounting for interest-bearing or other financial instruments.

10.14 **FASB 5 describes contracts which do not involve the transfer of insurance risk, but does not elaborate on what the term means. FASB 97 refers to contracts which do not incorporate significant insurance risk as that concept is contemplated in FASB 60.**

10.15 FASB 60, Accountinq and Reportinq by Insurance Enterprises, was issued in June 1982 and includes in paragraph 40 almost identical wording to paragraph 44 of FASB 5.

10.16 **These standards indicate that American authorities have seen a need to give guidance to the profession on how to account for insurance contracts which do 'not involve the transfer of risk. However it is apparent from our enquiries that it has not only been American insurance regulators who have been concerned**

over the manner in which the insurance industry deals with and accounts for certain types of reinsurance contracts which are regarded as being the equivalent of financial arrangements. The authorities in the United Kingdom have also been concerned for a number of years. (See section 5.)

10.17 These concerns are evidenced by a paper Accounting for Non-Life Financial Reinsurance: A Discussion Paper issued in December 1991 by the ICAEW2.

10.16 The paper, while primarily concerned with accounting for reinsurance companies rather than the insured parties, gives very useful guidance for determining if transactions which may be insurance in form are insurance in substance for accounting purposes.

10.19 **The paper opens by outlining the characteristics of financial reinsurance. It** says:

> ***(a) The premium payable by the cadent and the cover provided by the reinsurer is arrived at by reference to a discernible or explicit application of an interest rate assumption.'***
>
> *(b)* ***The financial outcome, or range of possible results, for each party is determinable and generally documented at the outset, because with financial reinsurance the reinsured will always make a recovery from the reinsurer;***
>
> ***(c) The reinsurer's profit is generally not dependent upon the amount of claims arising under the contract.***
>
> *The interaction between a stated or implied interest rate and the quantification of the premium payable, the cover provided, and the amount and timing of reinsurance or other recoveries is not present in conventional reinsurance and is a feature which makes financial reinsurance special and in need of appropriate accounting treatment.*

10.20 The paper says later:

> ***In substance, financial reinsurance contracts are often agreements whereby the ceding company Is effectively placing a time deposit with the relnsurer as an investment or is borrowing funds from the reinsurer to finance the payment of claims which loan is required to be repaid As explained below, this type of agreement should not be accounted for as a contract of reinsurance but should be treated as a _financing arrangemenf'.***
>
> *The need for authon.tatlve guidance arises because, If financial reinsurance is accounted for as conventional reinsurance, the balance sheet of both the ceding company (or relnsured) and the assuming company (or reinsurer) may give a misleading view of their financial positions,' published underwriting and operating results may also be distorted.*

10.21 The paper lays stress on the question of transfer of risk

> ***Transfer of Risk***
>
> ***13 A contract of Insurance is character/sod by:***
>
> ***a)*** ***the indemnification of the Insured against loss, liability or other consequence of an adverse event by the insurer on payment of a premium,- and***
>
> ***b)*** ***uncertainty as to whether the loss event will occur or when***
> ***it will occur.***
>
> *In other words, insurance risk should be inherent in the contract. ...*
>
> *14 Different elements of risk may be present in a contract of reinsurance, as described below. However as indicated ......, the existence of certain elements of risk, in isolation, may not be sufficient evidence of the transfer of 'Insurance risk' from the ceding company to the reinsurer.*

In this way the paper recognises that a contract, although in the form of a contract of insurance because of the existence of "..certain elements of r!sk.." may not involve a transfer of insurance risk for accounting purposes.

10.22 **The Discussion Paper then identifies the two principal elements which are representative of _insurance risk'. These are:**

(a) ***Underwriting risk***	***Uncertainty as to the occurrence of the loss event and/or the ultimate amount of any claim payments.***
(b) Timing risk	***Uncertainty as to when gross claims are paid and consequently when reinsurance recoveries will become due to the cadent from the reinsurer.***

10.23 Elements which are present in same arrangements, but which do not represent the transfer of insurance risk, include:

(c) ***Investment return risk***	***Investment income earned on premium cash flows is a component of premium pricing or rating. The Investment return risk is the uncertainty as to the ultimate investment return which a reinsurer will earn, other than by reason of the timing risk, on net moneys accruing under a reinsurance contract.***
(d) Credit risk	***Risk borne by the cadent that the reinsurer, by reason of insolvency or otherwise, does not meet its obligation to pay losses, return premiums or profit commissions under the reinsurance contract. ...***
(e) ***Expense n.sk***	*Uncertainty as to whether expense loadings in the premiums ceded to the reinsurer will be sufficient to meet the operating costs of the reinsurer.*

10.24 We observe that accountants do not regard investment return as an element of insurance risk.

10.25 **We observe that since 1975 there has been authoritative guidance available, in terms of the hierarchy of guidance outlined by Trow, in the form of FAS8 5. This guidance has been strengthened by later pronouncements in the United Kingdom as well as the United States. It has not been contradicted by authoritative guidance from any accounting authority in this period.**

Current view of accounting for. the a_rranements

10.28 **We conclude, in terms of the both the substance of the arrangements and the recent guidance given by FAS8 5 and the ICAEW paper, that the arrangements were the equivalent of a financial arrangement for which the appropriate accounting treatment would recognise the interest accruing on a compounding basis on the investment of the _premium` in zero coupons bonds/the DK8 deposit.**

10.27 **Our conclusion is supported by a number of those who gave evidence or made submissions to us, as well as by the Sank's auditors and by Coopers. Their comments are set out in the following paragraphs.**

10.28 Trow said in a written statement:

> 2B. ***Speaking In Idealistic terms, it appears to be Inappropriate for the arrangement to be recorded by the accountant as an Insurance scheme. This is mainly because the Insurance company has accepted no risk for bearing losses In excess of the amounts pro arranged as the proceeds of the policy. Likewise, the Insurance company does not retain any of the premium If the loss suffered by the BNZ happens to be a lesser amount.***
>
> **29.** *Although the legal form Is a properly constituted Insurance policy with an insurance company, the economic reality of the circumstances, In the absence of any risk taking by the insurance company, Is merely the placing of funds on an interest bearing deposit for a term of five years. The arrangement therefore, would appear to be more appropn'ate/y recorded as an interest bearing deposit for five years with Income from the deposit recorded accordingly.*

10.29 **Ms E.M. Hickey a partner and the National Director of Accounting of E & Y, whose responsibility was to provide technical advice on accounting issues to Gerty, the partner of E & Y responsible for the audit of the BNZ, also made submissions on the issue. She said at p.611:**

> ***It [treatment as an investment} is clearly the preferred treatment if we look at the situation now. It was in my view the best available treatment when I looked at it in 1990...***

(Hickey then went on to argue that "appropriate" use of the matching concept as used by E & Y was an acceptable accounting alternative in 1988.)

10.30 Mr P.L. Hays, a chartered accountant giving evidence as an expert witness on behalf of certain of the 1990 directors gave his view at p.92, 2nd hearing:

> ***SO using my knowledge of today and not trying to make judgments as to back in 1988 or 1990, I would see that In the way the document Is couched and I haven't read the detailed document but that with the, obviously there are some uncertainties and so on that recover nevertheless you could expect that people acting rationally you would normally end up the money coming in on the dates that were specified and the money's well protected, there was no, presumably no risk of the ability to collect the money on the due dates, the three lots of 10 million and then the $170 million and those circumstances, the substance of a transaction was a financial instrument. That's with my, that's today if I had that matter put before me that's the way I would look for it to be handled.***

10.31 The Bank received advice from Coopers in an Operational Review Report presented to the Bank in March 1991. That report said, in part:

> ***Substance of Transaction***
>
> 5.4 ***Whilst the form of the arrangement is structured ` as an indemnity/.Insurance arrangement, the substance of the arrangement Is a five year coupon Investment. This conclusion Is supported by the fact that:***

> ***a) timing of payment of claims submitted by 8NZ can be varied at the option of the indemnifier;***
>
> ***b)total payments to the 8NZ are predetermined..***
>
> ***5.5 As there is no transfer of risk, the above arrangement is not in our opinion an Insurance contract.***
>
> *Accounting T,!ealment*
>
> ***5.6 FAS8 5 paragraphs 44 and 45, and FAS8 97 paragraph 15, state that where there is no transfer of risk and part or all of the premium paid Is in the nature of a deposit, then the arrangement should be accounted for as an investment In accordance with the substance.***

10.32 **Notwithstanding some of the comments made to us the Bank appears to have accepted, at least since 1991, that the treatment of the arrangements as a financial instrument was thereafter the correct method. The Operational Review report of Coopers (see above) was considered by the Operational Review Committee, comprising Sir Michael Fay, Mr D.G. Sadler and Mr L.C. Pyne at a meeting on 12 April 1991. The minutes of that meeting record:**

> ***Don She/ton*** **[then Chief Financial Officer}** ***then raised the issue of the bad debt Insurance.***
>
> ***He commented that Coopers & Lybrand were prepared to /eave the treatment as It was as they considered that a change at this time would not provide a "true and fair v/ew". * On the other. hand, Ernst Young were not now happy with the current treatment and wished to change It at this year end.***
>
> *Michael Fay queried what the auditors attitude had been in previous years.*
>
> ***David Sad/or commented that probably the best alternative was to continue with the status quo and note the correct treatment in the accounts.***
>
> **[*We note that Coopers' view as recorded in these minutes** *does* **not accord with their written report or with their evidence to us. See para [16.31].]**

10.33 Although there is, as we shall see later, quite a wide divergence of opinion as to what could have been reasonably required of the Bank, by using the knowledge of generally accepted practice in 1988 and later years, there at least appears to be unanimity on the accounting approach which could now be considered as the correct treatment and reflecting best international practice.

10.34 That "most correct' accounting treatment for calculating the benefit of an investment transaction is generally referred to as the "Yield to Maturity" or "YTM" method.

10.38 The use of the YTM method would have recognised the substance of the arrangements, the substance being the investment of a "premium" of $110 million in zero coupon bonds/a deposit maturing on scheduled dates at amounts totalling $200 million, in other words a -financial instrument". It would not permit the recognition as income of any more than the amount of interest earned by the Bank over the particular accounting period.

10.38 The YTM method is a method of calculating revenue derived from the compounding interest accruing on the zero coupon bonds/deposit over their five year term. The revenue as thereby derived is matched with expenses in accordance with the .matching principle. and with the Bank's own General Accounting Policy. No anticipation of income is possible.

10.37 The impact of the use of the YTM method on the profits of the Bank for each accounting period is outlined in section 11.

Determination of the appropriate accounting treatment for the arrangements

10.38 Submissions made to us on behalf of the Bank, certain former directors of the Bank, and the Bank's auditors have placed heavy emphasis on ascertaining the accounting approach considered acceptable at the relevant times throughout the life of the arrangements rather than forming opinions with the benefit of

hindsight. **We agree** with these submissions.

10.39 This report therefore seeks not only to determine the most desirable accounting practice in today's terms but also to determine those practices which could reasonably have been followed by the Bank over the full five year period of the **arrangements.**

10.40 **We apply.the framework outlined in this section to the circumstances of each accounting reporting period when we consider the Bank's methods of accounting for the arrangements and their impact on each set of the Bank's published financial statements.**

11.0 OVERVIEW OF HOW THE BANK HAS USED AND ACCOUNTED FOR THE COSTS AND BENEFITS UNDER THE ARRANGEMENTS FROM SEPTEMBER 19BB

11.1 In the previous section we concluded that the arrangements were in substance an investment, with the Bank paying a premium of approximately $110 million and receiving back $200 million on a fixed repayment schedule, producing a yield of around 13.7 per cent per annum on that investment.

11.2 While the Bank could make claims for any amount up to $200 million at any time over the five year period, it would only get back $10 million at the end of March 1990, $10 million at the end of March 1991, $10 million at the end of **March 1992 and $170 million at the end Of March 1993.**

11.3 **The arrangements produced for the Bank $90 million of earnings over five years. If the arrangements had been treated as an investment that income would have been incorporated in the Bank's revenue on an accrual basis over the period.**

11.4 However, the Bank on several occasions posed the question of itself whether it could bring some or all of that $90 million of net revenue into its reported income earlier than would apply if brought into its income on an accrual basis.

11.5 **At various times the Bank appears to have considered several possibilities. The two extremes, assuming for the moment they were both acceptable accounting treatments, were:**

> **First, the Bank might have claimed the full $200 million at 31 March 1988. Had it done so it would have been required to charge the full premium against income at the same time, thereby enhancing its immediate profit by the maximum of $90 million;**

> Alternatively, the Bank might have expensed the premium over some or all of the five years but not made any claim at all until the last year of the arrangements, 1993. Following this course would have meant that the Bank's profits over the first four years of the arrangement would have been depressed by both the amount of the premium expensed and the amount of the income foregone on the investment in the premium (about $40 million per year), while profitability in 1993 would have been enhanced by around $180 million ($200 million claimed less premium expensed and average accrued interest foregone of $40 million in that year). Effectively it would have established a sinking fund over the early life of the policy.

11.6 The Bank's actual taking of benefits under the arrangements fell between the two extreme possibilities outlined above. The Bank recognised the following income benefits in its financial statements over the years:

Benefits "claimed" by the Bank in each year

Year ending	Benefit taken
31 March 1989	$40 million
31 March 1990	**$94 mHlion**
31 March 1991	$38 mHlion
31 March 1992	$ 8 mHlion
31 March 1993	$22 mHlion

11.7 **The net impact on the Bank's reported profitability over these years, taking into account the amortised premium and the foregone interest on the Bank's investment in the premium was as follows:**

The net impact on the Bank's annual profits

Year	Benefit	Cost*	Profit Impact
1989	$40 mn	$37 mn	$ 3 million
1990	$94 mn	$39 mn	**$55 million**
1991	**$38 mn**	$40 mn	**($2 million)**
1992	**$ 8 mn**	$42 mn	**($38 million)**
1993	**$22 mn**	$42 mn	**($20 million}**
Totals	**$200 mn**	$200 mn	**Nil**

computed by adding the amount of the premium amortised each year ($22 million) to the amount of interest the Bank would have earned on the money invested in the premium.

11.8 **Had the "yield to maturity" or "YTM` method been followed the net impact of the arrangements on the Bank's reported profits would have been as follows (inoluding a comparison with the Bank's treatment):**

Contribution to the Bank's reported profits

Year	YTM	Bank*	Difference
1989	$15 mn	$18 mn	$3 mn
1990	$17 mn	$72 mn	$55 mn
1991	$18 mn	$16 mn	($ 2 mn)
1992	$20 mn	($16 mn)	($36 mn)
1993	$20 mn	0 mn	($20 mn)
Totals	$90 mn	$90 mn	$0 mn

*** Computed as the amount of the benefit taken in each year less the amount of premium charged against that year's profits**

11.9 There would have also been influences on a number of items disclosed in the **Bank's published financial statements. Use of the YTM method would have meant that the Bank's disclosed annual charges against income for debt provisioning, instead of being reduced by $40 million in 1989 and $54 million in 1990, would have been unaffected. Other income and expense lines in the profit and loss statements would also have been affected because in some years the Bank used benefits taken under the arrangements to offset the premium amortised and the interest foregone.**

11.10 Trow expressed certain views to us on the broad issue of the Bank's utilisation of the arrangements. He said in his written statement:

THE EXTENT OF PROFIT DISTORTION

The extent of the profit distortion can be ascertained by firs! determining how !he $90 million income should have been spread over !he 5 year pen'od. The spread should ideally have been in accord with !he interest accumulation on the premium of $110 million, as shown **[he repeats & similar table to that set out above].**

...It should be noted ... that !he $55 mil/ion overstatement of profit for 1990, the only year in which significant over statement occurred, is nowhere near !he $160 mil/ion maximum overstatement envisaged for one year, as outlined in [his] explanation of profit smoothing..

Likewise the actual understatement of profits in 1991 ($2 million) 1992 ($36 mil/ion) and 1993 ($20 mi//ion) is markedly less than !he $40 million per annum envisaged in !he arrangement for profit smoothing as explained. ... These figures serve to confirm that the Bank of New Zea/and applied !he proposed arrangement for credit insurance and associated profit smoothing to only a limited extent. **[Original emphasis}**

PART 8V_

CONSIDERATION OF THE SANK'S_
PUBLISHED FINANCIAL STATEMENTS_
FROM SEPTEM8ER 1988 ONWARDS_

12.0 METHODOLOGY OF OUR REVIEW OF EACH SET OF FINANCIAL_ STATEMENTS

12.1 In this Part we review each of the Bank's published financial statements from September 1988 to September 1992, consider whether the accounting treatment used by the Bank was appropriate at each relevant time and, if not, whether any resultant influences on the Bank's reported profits and/or net worth were sufficiently material to impact on the truth and fairness of the Bank's published financial statements.

12.2 For each set of the Bank's financial statements examined we calculate, where **relevant, the difference between the impact of the Bank's accounting treatment of the arrangements on:**

a)operating profit before doubtful debt provisions and tax;

b)profit and loss account charge for doubtful debt provisioning

c)operating profit before taxation and extraordinaries;

d) the level of the Bank's doubtful debt provisions (general and specific combined) as disclosed in its balance sheet;

e)the level of the Bank's shareholders' funds;

compared with the outcome if the YTM method had been applied.

12.3 The application of the YTM method would result in the inclusion in the Bank's -interest income` of the amount of interest earned on the investment of the premium payment. To calculate the differences between the application of the YTM method and the Bank's treatment it is necessary to:

a) reverse the charge to `other operating expenses` made for the amortisation of the premium; and

b) substitute the correct amount of accrued interest for any influences on the Bank's interest income already included by the Bank; and

(c) reverse any influence of the arrangements on the Bank's annual charge for provisions for doubtful debts both in the profit and loss account and in the balance sheet; and

d) adjust the level of the Bank's disclosed shareholders' funds for the income effects, after tax, of the difference between the Bank's reported income and what it would have been if the YTM method had been applied to the arrangements.

12.4 We have used the YTM method as the starting point for calculating variances. We have not assumed that the YTM method was necessarily the only one for the Bank to use to account for the arrangements in any of the early years. That is a matter for consideration in the course of our analysis.

12.5 We reviewed the accounting treatment used by the Bank for each reporting period in terms of the framework for determining the appropriateness of any particular accounting policy we outlined in section 10.

12.6 Where the Bank's accounting treatment does not accord with SSAPs, and/or with the Bank's general accounting policies, and/or with authoritative guidance available, we then review the materiality of the effect of the influences resulting from the Bank's accounting treatment as compared with the YTM method.

12.7 If the resultant variance in either the Bank's published level of profit before taxation and extraordinary items or published level of shareholders' funds appears to be "material", we then consider the work of the auditors and all relevant evidence and submissions received.

12.8 If we reach a conclusion that the financial statements of the Bank tor s particular period do not present a true and fair view of the results for that period or the affairs at that time we then examine the actions of the directors and auditors in approving those financial statements.

12.9 Where we have recalculated any influences on the Bank's financial statements details of our calculations and adjustments are set out in Appendix K

13.0 MATERIALITY

13.1 Before looking at each set of financial statements we need to consider what is meant by the accounting concept of "materiality" in the context of published financial statements.

Application of the appropriate accounting standard

13.2 The first point of reference Is the relevant New Zealand accounting standard which is SSAP 6 *Materiality In Financial Statements. ......*The Statement says:

5.1 *Subject to compliance with statutory or other roqu!remenfs binding upon the reporf/.ng ontlfy, financial statomonts should be props,ed having regard to the matoriallty of !ho information to bo given.*

5.2 ***In deciding whether an !tom Is material, its naturo and its` amount should both be taken info account. Ordinarily, !ho nature and the amount Of an item should be .valuated together, although in parf/.cular circumstances either alone may have to be recognlsed as the decisive factor.***

5.3 ***For the purposes of determining whethor an amount is matorial -***

a) *items of the same Or a simHar catogOry shOuld be cOnsidered In aggregate,'*

b) *prOfit and lOss statement |fems for which separate disclOsure is not made may be aggregated even thOugh they are dissimilar.*

5.4 ***When considering the materiality of an item, Its amount should be compared with an appropriate baso amount.***

5.5 ***In applying the materlallfy fest, the following should also bo considered -***

a)the purpose of the financial statements in question,'

b) the identify, and the Information needs, of the usors Of those statemonts,- and

13.3 The Appendix to the Standard states:

Criteria to Assist in Determining Materiality

Determining materiality of an item is essentially a matter Of judgment. In making that judgment the following comparisons might be made where applicable:

(a) ***Profit and loss statement items (including extraordinary items) could be comparod with the pretax profit beforo oxtraordinary Roms for the current year or the average pro-fax profit for the last, say, three years (including the current year), whlchovor is the more relevant measure of profit having regard to the trend Of the business ovor***

that period. Where the tax charge is not fully equal to a charge at current tax rates on pro-tax profits, or an item being considered for adjustment is not tax deductible, it may be more appropriate to evaluate the materiality of the item based on the after-tax profits.

b)Balance sheet items could be compared with the lower of:

(i) total share capital and reserves, and

(ii) the appropriate balance sheet class total, for example, current assets, non-current assets, current liabilities, non-current liabilities.

c) Where an item is subject to compan'son with the base amounts In both (a) and (b) above, the more stn.ngent test should prevail.

To assist in practical situations the following percentage limits are suggested as gulde!ines.-

a) A variation in amount which is equal to or greater than 10 percent of the appropriate base amount, could be presumed to be material unless there is evidence to the contrary.

b) A variation in amount which is equal to or less than 5 percent of the appropriate base amount could be presumed to be immaterial, unless there is evidence to the contrary.

(c) ***Whether or not a van'ah'on which lies between 5 and 10 percent of the appropriate base amount could be material is a matter of judgment and depends upon the particular circumstances of the case.***

In providing these percentage limits it must be stressed that percentages are not 'magic numbers', and all circumstances surrounding the items, the reporting entity, and the users should be taken into account.

Submissions

13.4 Trow, on behalf of the Bank, submitted at p.310 that the appropriate basis for measurement of materiality was against:

the BNZ's normalprofit before tax.

Trow asserted at p.310 that this figure was:

...over $200 million..

13.5 In response to questioning he elaborated on this. He said at p.310;

...you should be aware of the fact that when auditors look at impact on profit numbers you're not quite so concerned with the actual result for the year although that of course Is important but you've got to make sure that you retain some measure of commonsense that you look at what is the normal profit for the organisation or what Is the Investor expecting as the profit for the company and one attains this by looking at the profit performance over the years...

13.6 Later he said at p.336

Our New Zealand Standard on materiality I don't think mentions the term normal profit. ... I think It talks about looking at the profit pattern over the years which my interpretation Is to try and establish what a normal profit is. ... You never get a normal profit that's an unusually /ow amount because the business just goes out of business If that's the case and I would hold very strongly to my view that you refer to normal profit.

13.7 **When he was reminded that the standard does not mention 'normal' profit and provides for reference to the current year's profit if this is the more relevant, Trow said at p.337:**

Look /et's not lose reality here. 171 get that Standard changed or try and influence It if I can. You think about the investors and the market place. What matters to an Investor I mean we look for certain profits from companies. We know there's an expected /eve/ and If you have three or four abnormal years when there 's practically no profit it's absolutely absurd to re/ate some distortion to that particular circumstance. It just doesn't make sense at all. You 've got to look at it In [the] context of the organisation you're looking at.

13.8 At a subsequent appearance before the Commission Trow drew our attention to a section of the Commission's 1989 Report Capita\ Structure and Financial Reporting in New Zea\and when the Commission's view on the subject was:

> ***8.212 Materiality Is an Important qualitative characteristic in financial reporting. By drawing attention to the Items which are significant, users of financial reports are In a better position to make informed judgment. it is important to have a definition expressed in terms of the circumstances where the disclosure of the Item may influence the making of decisions by users of the financial statements.***
>
> ***821.3 Whether an item is or Is not material Is ultimately a matter of judgment. If quantitative guidelines are quoted, they will tend to be read as definitive boundaries to the exclusion of the exercise of judgment. The accounting standard includes 5% and 10% guidelines and this should be a sufficient guide to preparers of financial statements.***
>
> ***8.21.4 It is considered that materiality should be defined by stating that s statement, fact, or item is material if, given full consideration to the facts and the surrounding circumstances at the time of completion of the financial statements, it is of such a nature that /ts disclosure, or the method of treating It, Is necessary for a true and fair view and would be likely to Influence the making of decisions by the users of the financial statements.***
>
> ***821.5 It is also considered that no quantitative guidelines need be given.***

13.9 Trow then explained his earlier reference to "normal profit" at p.29, 2nd hearing:

> ***I certainly had to think as to where I'd got this expression -normal profit" from and it obviously came from the time when I was working In the United States and we were frequently using the term because both of those references [two texts he cited} are from North Amen.ca and I hope that I will be able. to show ..... that there was some credence to my term -normal Income`.***

13.10 Hays also gave evidence to the Commission on materiality. He said at p.99, 2nd hearing:

> ***I think it's a little bit unfortunate really that in New Zea/and we've had this accounting standard No. 6 which has had this appendix which has had those different measures in materiality. We are the only country left now I think the Australians have deleted that appendix and I would think that when the accounting financial reporting standards get approved In due course under the new Financial Reporting Bill that that particular appendix***

won't be part of it. In other words the emphasis should come back on what's materiality really about. In other words how will it affect the misstatement or non-disclosure whatever It may be, how does it affect the decisions of the users of the financial statements and that ! think then really becomes the Issue and becomes for me how to assess this amount of abnormal change in relation to the overall history of the bank.

13.11 **When questioned on the use of the term "normal profit" by Trow, Hays said at p. 105, 2nd hearing:**

That was one area that ! wouldn't agree with Professor Trow. A normal year is not in my view what he suggested which was a desirable or expected !eve! but to me a normal year is what that organisation that entity has achieved and its trend in achieving those in the past.

and at p.102, 2nd hearing:

There are parts of Professor Trow's discussion on a normal year, a normal profit which I agreed with and some parts that ! did differ. My approach to materiality when we have a year when profits are unduly !ow or a company has made a loss has been to assess materiality in relation to actual results of the company round about that time immediately preceding and that has been my basis of a normal profit of what the company has actually achieved in those other years.

Our view on the issue of materiality

13.12 **We have considered these submissions carefully. In our view judgments on materiality in relation to the financial statements of the BNZ, made in terms of the guidance set out in SSAP-S, should take into account the following general considerations:**

(a) **Over the relevant period the BNZ was the country's largest bank, a publicly listed company and a major borrower of funds in the domestic market. The Bank was subject to intense public and shareholder scrutiny as a result of its various difficulties and, most**

recently, its sale to the National Australia Bank

(b) The arrangements entered into by the Bank were most unusual ones for a Bank either in New Zealand or anywhere else in the world. Neither shareholders nor depositors would have any reason to expect the Bank to be influencing its levels of provisioning or profitability by the use of such arrangements.

(c) The Bank suffered a very large loss in the year to 31 March 1989. In the nature of things the impact of such a loss could be expected to be felt by the Bank for many years. Any past pattern of profitability would not be particularly relevant when considering the Bank's position in the next year, to 31 March 1990.

(d) Both the directors and auditors could expect that the Bank's profitability for 1990 and later years would be under very close scrutiny as the market tried to determine if the Bank was going to make a successful return to profitability.

(e) At the time of publication of the Bank's September 1990 half year report the Bank also announced that, subsequent to balance date, it had provided for very substantial additional doubtful debts and was being restructured.

13.13 We remain of the opinion expressed in our 1989 report already referred to. While percentage guidelines provided by the Appendix to 8SAP-6 are useful, those measures are merely an aid to determining whether a departure from the true profit before tax is sufficiently significant to impair the ability of users of the financial statements to make informed judgments. The question is whether the misstatement is likely to influence the making of decisions by users of the financial statements.

Position of the auditors

13.14 **In the course of any audit there will be differences of view between the auditors and the statement preparers over the proposed accounting treatment of various items or transactions. Normally these audit differences or "unders and overs" will be discussed between the auditor and the chief executive or chief financial officer of the company concerned.**

13.18 **Where there are differences with the client company the auditor will prepare an "unders and overs schedule" or "schedule of audit differences" in order to determine whether or not, after taking these differences into account, the impact on the company's profit or position is of such magnitude that the results as reported by the company are materially at variance with the auditor's assessment. The audit of the BNZ followed this practice.**

13.16 **It will be seen that in certain years in the period under review E & Y relied on their "unders and overs" schedules in assessing the effect on financial statements of the Bank's accounting treatment of the arrangements and in deciding whether to give an unqualified audit report. For this reason we found it necessary to review the "anders and overs" schedules.**

13.17 **This review process has required us to examine the Bank's issue of Perpetual Subordinated Capital Notes in 1988, which was not covered by our terms of reference but which feature prominently in.the u.nders and overs schedules.**

14.0 FINANCIAL YEAR ENDED 31 MARCH 1989_

Interim financial statements for the six months ended 30 September 1988_

The financial statements

14.1 In the six months to 30 September 1988 the Bank recognised as income $20 million of the amount claimable under the arrangements. This amount was used to reduce the charge for provision for doubtful debts made against profits.

14.2 The effects of the Bank's accounting treatment on its financial statements compared to use of the YTM method, include:

Profit and Loss No 6 mths to 30!9!1988_

	Bank	YTM_	Variance_
Operating Profit before provisions and tax	$218 mn	$236 mn	-$18 mn -7.6o/o*
Provisions for doubtful debts	$188 mn	$208 mn	-$20 mn -9.Bolo
Operating profit before tax	$ 30 mn	$ 28 mn	+$2 mn +7.1%

Balance Sheet as at 30!9!1988_

	Bank	YTM	Variance_
Provisions for doubtful debts	$319 mn	$339 mn	
Shareholders' funds	$1,074 mn	$1,073 mn	-$2Omn -5.9o!o

Throughout these comparison tables the sign (`+` or `-`) indicates whether the

particular item as disclosed by the Bank is larger or smaller than the resultant figure if the YTM method had been used.

The appropriateness of the Bank's accounting treatment for the arrangements

14.3 **The influence of the Bank's use of the arrangements on its profit before tax was only $2 million. The accounting method used complies with the matching principle (see paras 10.7 and 10.36) because it approximately matches the Bank's costs of the arrangement with the revenues recognised. We observe that the method used does not fully accord with recognising the substance of the arrangement because the arrangements are accounted for as an insurance arrangement and not as a deposit. We note that the method used is nevertheless prudent because it does not involve the anticipation of income. We observe that the method used does not accord with the overseas guidance available in FASB 6 (although the end result is very similar).**

14.4 **We** will **not review the submissions received on the interpretation of accounting standards and guidance at this point since the impact of the Bank's accounting treatment for the arrangements on either its results or balance sheet is not material. However it is relevant to consider the advice received and the decision taken by the Board of the Bank on the use to be made of the arrangements during the half-year.**

Advice from Ernst and Wh/nney

14.6 The first recorded advice provided by the Bank's auditors was included in s letter dated 1 June 1988 to Clack from Garty. It said:

> ***Following discussions with you recently regarding your Indemnify Risk Insurance Policy we now set out our agreement In relation to the following two matters.'***

We agree with the accounting treatment as discussed in relation to the premium and principal cover of the insurance policy. The insurance premium is to be expensed on a straight-line basis over the life of the policy (5 years) In the accounts of the Bank. There is no requirement for the Bank to disclose in the notes to the accounts the amount of insurance cover held. The Bank may wish to in future years word an appropriate note should the Insurance policy be used to onset the enact of any bad and doubtful debt write-off.

The Board's decision on utlllsation of the arrangements in the Interim financial statements

14.6 **At a number of meetings of the Board during October 1988 the directors deliberated on the Bank's half-yearly financial statements to 30 September 1988.**

14.7 **After considering a number of alternatives, including that the Bank should take the benefit of the full $200 million under the arrangements in these financial statements, management recommended to the Board that the Bank apply $60 million of the benefits available under the arrangements against specific provisions in the period.**

14.8 **Despite having that recommendation from Bank management to claim $60 million under the arrangements, the directors decided to limit the amount to be claimed to an amount which did not exceed the sum of the premium &mortised** to that point and the income already foregone on the investment in the premium. On this basis the Bank took an income benefit of $20 million in those accounts for the half year.

14.9 Minutes of a meeting of the Board of the Bank on 20 October 1988 include:

> ***Dr Lojkine commented that she was under the impression that this policy was a method of putting aside income akin to a reserve to cover future large unexpected losses. She considered that at this point the Bankshould only uh'llse an amount equivalent to that effectively paid to date under the policy arrangement. ...***
>
> ***Deputy Chairman [Campbell] commented that with the level of provisioning currently being undertaken it was unlikely on information currently available that the Bank would sustain further substantial losses. Group Chief Executive advised that at present the Bank was only making provisions and that these possible losses were not being written off until absolutely necessary. He noted that if the Bank made a claim of $60 million it would be against provisions and not wn.te-offs at this stage.***
>
> ***Observ/._ng that there was some reluctance to make a substantial claim against the policy Assistant General Manager [Tennent] commented that the outside auditors considered that the Bank could place up to $200 against the insurance policy* and they had initially questioned the need to make a note in the accounts. Bidders are aware of the existence of the policy.***
>
> ***Mr Pearson stated that he did not feel comfortable with the proposed course of action and felt It may be better to disclose what has happened and state that we do have an insurance policy which can be utilised if necessary. In support, Dr Lojkine commented that she could not support a claim greater than the premium paid to date, namely $20 million. Mr Pearson agreed.***
>
> ***Group Chief Executive advised that there had been a change in the basis of provisioning and this was now significantly different to that in the past. There had been a much more determined effort to assess possible present and future provisions. ...***

[*Gerty has informed us in evidence that this was not an accurate statement of E&Y's view.]

14.10 **Minutes of a further meeting of the Board on 26 October 1988 include:**

> ***Dr Lojkine felt that if the Bank claimed $40 million against the insurance policy some disclosure should be made. However if a claim of only $20 million was made this could be treated as a contra and no disclosure would be necessary.***

14.11 The minutes of a further Board meeting on 31 October 1988 record

> ***A draft set of half-yearly accounts was tabled for Board perusal. These accounts included an application of $20 mu/ion against the insurance policy.***
>
> ***Notwithstanding the fact that the Bank could uh'llse more of the insurance policy it was agreed that the current set of accounts provided an accurate reflection of the Bank's accounts at the present time.***

14.12 **It seems clear that the directors took a policy decision that the amount of benefit 'claimed` under the arrangements should not exceed the amount of premium which had been written off against profits together with interest accrued to that point from the investment of the premium payment.**

14.13 The implications of the Board's decision in this area are reflected in a number of the Bank's internal records. The following extract from the minutes of a meeting of the Bank's Assets and Liabilities Management Committee dated 14 March 1989, chaired by McCay and including a number of the Bank's senior **executives, included:**

> ***capital Base Supplement***
>
> ***As referenced previous minutes,`***
>
> ii) *Loss Insurance paper covering possible treatments and unwinding of policy* [which had been requested at the meeting of the committee of 10 March 1989} *not received - Chairman advised that there was no prospect of the policy being used this year beyond the present level ($40m).*
>
> ....

14.14 **Another reference to the Board's policy was in an internal management memorandum from Stockwell, Senior Manager Capital Markets, Investment Banking Group to the General Manager Investment Banking dated 2 May 1989 (referred to at para 3.14. The memorandum is headed `BNZ CAPITAL ADEQUACY PROPOSALS FOR GENERATION OF TIER ONE CAPITAL'. Included in the memorandum, which includes consideration of winding up the** scheme, is:

> *Claims on the [Credit and Investment risk insurance} scheme have been limited to date to the amount of accrued annual premium and funding opportunity cost resulting in a neutral profit and loss position.*

At the conclusion of a lengthy appendix to the paper headed `BNZ INSURANCE POLICY` it is stated:

> *7. CONCLUSION*
>
> ***Under the present accounting policy there Is no monetary benefit to the Bank in maintaining the insurance policy, however there is presentational benefit.***
>
> ***This presentational benefit is gained by the Bank being able to move a $40M cost from bad debts expense and provisions into interest charges and insurance premium expense without any adverse impact on the Profit and Loss but contemporaneously showing better performance via reduced provisions.***

Appendix 2 to the paper, dealing with proposals to increase the Bank's Tier One capital, and headed `OPTION 1 Use Insurance Po\icy` says:

> ***Although It has been decided to utlllse the Insurance Policy on an accruals basis over the term of the policy it may now be considered appropriate to accelerate the uti/isation of this policy in light of present Tier 1 capital constraints and future provisioning following Booz Allen's Investigations.***

14.15 **It is clear from this memorandum that the Bank's senior management regarded the Bank as having adopted a particular policy for the use of the arrangements which resulted in a neutral profit and loss position. Management was then (May 1989) looking at a review of that policy as one way of increasing the Bank's tier one capital. It is clear from the evidence that any contemplated changes in the Bank's policy were not pursued.**

14.18 In a written submission to us of 18 April 1993 Lojkine states:

> ***....the account/ng policy advocated by Mr Pearson and by me, and adopted by the Bank, meant that the Bank's financial statements for the above three*** *pen'ads* **[September 1988, March 1989 and September 1989],** ***were -true and fair- within the materiality standard.***

14.17 **As corroborated by Stockwell's memorandum the effect on the Bank's reported profits of this policy decision was almost the same as if the Bank had decided to treat the arrangements as an investment, although this was not explicitly stated.**

14.18 **RMcV, for certain former directors of the Bank, disputes that the actions of the 1988 Board constitute the establishment by the Bank of an accounting policy for the arrangements. They state in their submissions to the Commission:**

> ***.... The 20 October 1988 minutes note Dr Lojklne as saying that the insurance was available to cover future large `unexpected losses but that, -at this point- the Bank should only uti/lsa an amount equivalent to that paid to date. .... Mr Campbell's attitude was based on a lack of need at that time for a c/a/m, because the /eve/ of provisioning taken and the unlikelihood of the Bank susta/ning further substantial losses. There was reference in the minutes to the Group Chief Executive saying any claim would be against provisions only and not write-offs at that stage. Mr Tennent was noted as having told the board that the auditors said it could claim the full $200 million without a note in the accounts.***
>
> ***Mr Pearson was uncomfortable about a $60 mi///on claim and Dr Lo/kine agreed .they should only claim the premium to date.*** *Mr* ***McCay was then noted as having referred to the batter approach taken by the Bank to provisioning. The whole tenor of the minutes to a subsequent reader is that the Bank was now adequately provisioned, there was no need for m***

> ***substantial claim, and so one should not be made at that time. It was, however, clearly accepted that the possibility of a large claim was available in case of need in the future.***
>
> *In the 26 October 1988 minutes, there is reference to Dr Lo|kine feeling that a large claim should involve some disclosure, but if $20 million only was claimed, no disclosure would be necessary. The 31 October 1988 minutes adopted the $20 million claim for the half-year, but referred specifically to the Bank's ability to uti/ise more of the policy.*
>
> *There is nothing in those minutes which establishes for a subsequent reader that there was a board "policy" that only the premium payment should be claimed. Indeed the opposite appears - the minutes suggest that the old board felt that no claim was* ***then*** *appropriate because of the adequacy of provisioning and the lack of foreseeable losses at that time. In other words, the circumstances for which the insurance had been established, to meet large unexpected losses, had not then arisen. ......*
>
> *Indeed, if there had been .... a change in -policy" established by the previous board this would require a formal resolution of the board. There is no such resolution. ....* [Original emphasis}

14.19 We are satisfied that the Board of the Bank established a policy for the use of the arrangements in October 1988. This is confirmed by the minutes of the Assets and Liabilities Management Committee and in Stockwell's memorandum referred to earlier. Lojkine's evidence to and correspondence with us further confirms it.

Our view on the September 1988 financial statements

14.20 In our view the influence of the use of the arrangements in the Bank's reported profitability for the half-year to 30 September 1988 was not material. This is the direct consequence of the policy decision made by the Board to limit its benefit to an amount which offset the Bank's costs to that point.

14.21 **While the influence on the amount charged for the provision for doubtful debts, at over 10%, could be regarded as material** in **relation to provisioning, the end effect on profit was not material.**

14.22 We do not agree with this undisclosed adjustment to the Bank's stated charge for doubtful debt provisioning, certainly not without disclosing the arrangements. The level of doubtful debt provisioning is an important figure in the financial statements of a bank and any adjustments thereto should be disclosed. However we do not consider the omission to be sufficiently material to affect the truth and fairness of the Bank's financial statements for the half-year ended 30 September 1988.

Audited financial statements for the year ended 31 March 1989_

The_financial statements

14.23 For the full year financial statements to 31 March 1989 the Bank took the benefit of $40 million under the policy, all of which was used to reduce the disclosed charge for provision for doubtful debts.

14.24 The effects of this action on the Bank's published financial statements included

Profit and Loss Nc year ended 3113/1989_

	Bank	YTM_	Variance_
Operating profit before provisions and tax	**$348 mn**	**$385 mn**	**-$37 mn -** g.Solo
Provision for doubtful debts	$1,294 mn	$1,334 mn	
Operating loss before tax and extraords	**$946 mn**	**$949 mn**	+$3 mn +0.3o/o

Balance Sheet as at 31/3/1989	Bank	YTM	Variance	
Provisions for doubtful debts	$1,206 mn	$1,246 mn	-$40 mn	-3.20/o
Shareholders' funds	$389 mn	$387 mn	+$2 mn	+0.5%

The appropn.ateness of the Bank's account/nq treatment for the arrangements

14.25 The Bank continued to follow the accounting policy it established in October 1988. The benefits taken approximated the costs of the arrangements to 31 March 1989, despite the very large increase in the level of the Bank's doubtful debt provisioning. This treatment was in accord with the Bank's general accounting policy of matching costs and revenues and did not involve the anticipation of income. However the treatment did not fully accord with the substance of the arrangement and was not in accordance with available authoritative guidance (FASB 5). The impact on the Bank's profit was immaterial.

Our view of the March 1989 financial statements

14.26 In our view the Bank's treatment of the benefits it took under the arrangements in the year ended 31 March 1989, which followed the policy established by the directors in October 1988, while it did not accord with best practice, did not affect the truth and fairness of the Bank's financial statements for that period.

15.0 **FINANCIAL YEAR ENDED 31 MARCH 1990**

Interim financial statements for the half-year ended 30 September 1989

The financial statements

15.1 **Little evidence was submitted in respect of the half-year ended 30 September 1989 but it seems that there was no change in the accounting treatment and that the recognition of income was restricted to $20 million consistent with the two previous sets of financial statements. In preparing the following tabulation we have assumed that this $20 million was offset against the provision for doubtful debts.**

15.2 The Bank's use of the arrangements had the following influence on its published financial statements:

Profit and Loss No for six months to 301911989

	Bank	YTM	Variance
Operating profit before provisions and tax	**$117 mn**	**$137 mn**	-$20 mn - 14.6%
Provision for doubtful debts	**$98 mn**	**$118 mn**	
Operating profit before tax and extraords	**$18 mn**	**$18 mn**	**nil** 0.0o/o

	Balance Sheet as at 30/9/1989		
	Bank	YTM	Variance
Provisions for doubtful debts	**$1,304 mn**	**$1,364 mn**	-$60 mn -4.40/o
Shareholders' funds	**$838 mn**	**$836 mn**	+$2 mn +0.20/o

The appropriateness of the Bank's accounting treatment for the arrangements

15.3 **We understand the Bank continued to follow the policy established by the Bank's Board in October 1988. As a result the Bank's general accounting policy of accrual accounting was observed. There was no anticipation of income. However, as noted previously, the substance of the arrangements was not reflected in the financial statements and the available authoritative overseas guidance was not followed. The impact on the Bank's profit was not material.**

15.4 **The auditors understandably had little to say in the manor at that stage. The approach adopted by the Board, while not the exact requirement of a YTM approach, was not responsible for any material distortions in reported profit, and the "neutral|sing" of the effect of the arrangement excused the lack of any disclosure of the existence of the arrangements.**

Our view of the September 1989 financial statements

18.5 In our view the Bank's accounting for its use of the arrangements in the half-year ended 30 September 1989, which again followed the policy established in October 1988, while it distorted the charge for provision for doubtful debts, had no material affect on the truth and fairness of the Bank's financial statements **for that period.**

Audited financial statements for the year ended 31 March 1990

A. *The financial statements*

15.8 **In the year ended 31 March 1990 the Bank made extensive use of the arrangements. The Bank recognised as income $94 million of benefit which was applied as follows:**

Reduce provision for doubtful debts	**$54 million**
Reduce reported operating expenses	$22 million
Increase reported operating income	$18 million

15.7 **The effect of this level of utilisation of the arrangements on the Bank's financial statements included the following:**

Profit and Loss NC year ended 31/3/1990

	Bank	YTM	Variance	
Operating profit before provisions and tax	$293 mn	$292 mn	+$1 mn	+0.3%
'Provision for doubtful debts	$193 mn	$247 mn	-$54 mn	-21.9o/o
Operating profit before tax and extraords	$100 mn	$ 45 mn	+$55m	+/o

Balance Sheet as at 31(311990

	Bank	YTM	Variance	
Provisions for doubtful debts	$1,217 mn	$1,311 mn	-$94 mn	-7.2o/o
Shareholders' funds	$1,098 mn	$1,059 mn	+$39 mn	+3.7%

15.8 **These effects were not disclosed in the Bank's published financial statements. The apparent profit enhancement of $55 million appears material in relation to the Bank's reported profit before tax and extraordinaries for the year.**

B. ***The appropriateness of the Bank's accounting treatment for the arrangements***

15.9 The Bank's use of the arrangements in the year ended 31 March 1990:

a) does not appear to accord with the Bank's own general accounting policy of matching expenses and revenues;

b) does not appear to recognise the economic substance of the arrangements;

c) does not appear consistent with the policy of the Board established
in October 1988;

d)appears to involve the recognition of anticipated income

e) does not appear to accord with the authoritative guidance on the treatment of such arrangements (PASS 5).

f) appears to result in a material undisclosed misstatement of the

15.10 **We examine each of the matters in tum. We review the records of the Bank, the evidence of the parties involved and of independent expert witnesses, submissions made to us, and accounting literature over the period.**

(a) Matching Expenses and Revenues

15.11 **As previously noted, the Bank, when nominating its 'General Accounting Policies" in its published financial statements, states:**

> ***Accrual accounting is used to match expenses and revenues.***

15.12 Paragraph 4.2(b) of SSAP-1 describes the "matching principle' as:

> ***Matching of Expenses and Revenues. Under accrual accounting expenses and revenues are recognlsed as they are incurred or earned (rather than as money is paid or received) and recorded In the financial statements of the period to which they re/ate. Results for the period are determined by matching expenses with the related revenues.***

15.13 **The approach followed by the Bank in the year ended 31 March 1990 did not involve "matching'. The Bank recognised $94 million as income from the arrangements compared with the costs 'incurred' of one-fifth of the premium paid on the policy, $22 million, and the foregone interest of $17 million. If the Bank was to have matched costs with revenues taken it would have brought to charge against revenue an additional $55 million of the premium.**

15.14 **We regard YTM as the correct method by which to comply with the matching concept. It is simply a calculation of the compounding interest accruing on the investment of the .premium' thereby providing the Bank with increasing earnings over the five year term of the arrangements.**

15.15 For further discussion on the application of the matching principle to the arrangements see paras 15.36 to 15.40 and 15.106 et seq.

15.16 **We conclude that the Bank's accounting treatment for the arrangements in the year ended 31 March 1990 did not accord with the Bank's own general accounting policy of matching revenues and expenses.**

(b) Substance over form_

15.17 **The first of the *important cn.terla* as set out in SSAP-1, which should be considered in selecting the most appropriate particular accounting policy from the range of alternatives, is:**

> (a) ***Substance over form. Transactions and other events should be accounted for and presented In accordance with their substance, that Is their financial and economic reality, and not necessarily In accordance with their legal form.***

15.15 **The concept of 'substance over form" has been entrenched in accounting thought for many years. Early overseas reference can be found in Accounting Principles Board Statement No 4 issued in October 1970 by the Accounting Principles Board of the American Institute of Certified Public Accountants ("AICPA') which remains authoritative in the areas it covers. Included in chapter 2 are the basic features and basic elements of financial reporting, which include "substance over form". That term is described as:**

> ***Financial accounting emphaslses the economic substance of events even though the legal form may diner from the economic substance and suggest different treatment.***

15.19 **Later, in the same chapter, there is a further reference:**

> ***Although financial accounting Is concerned with both the legal and economic enacts of transactions and other events, many of Its conventions are based on legal mies, the economic substance of transactions and other events are usually emphaslsed when economic substance diners from legal form.***

15.20 **The Commission itself expressed a view on the question of "substance" over 'form" in its report Capital Structure and Financial Reportinq in New Zealand_ at the time of its presentation to the Minister of Justice in December 19893. Our report was three years in preparation and drew on mainstream accounting thinking at the time. This reference was in the Chapter .Proposals for Legislation' and under the heading "NON-COMPLIANCE AND .CREATIVE ACCOUNTING".**

After giving some background to the problems following the sharemarket crash, non-compliance with SSAPs and `Creative accounting` we said:

7.3 Some authorities approach the problems of reporting transactions of these kinds (If they are made known to the accountant or auditor) by preferring "substance" over "form", or "commercial effect" over "legal re/ationshlp". We think an accountant or auditor should exercise caution where his assessment of the substance or effect diners from the form or legal relationship. Sometimes, especially in the case of a dispute, the form or legal relationship prevails whatever one might think of the substance or enact. (Snook v. London and West Ridinq Investments Ltd. [1967!2 QB. 786 (C.A.), Bateman Television Ltd. v. Coleridqe Finance Co. Ltd [!969] NZLR 794(C.A.), [1971] NZLR 929 (P.C.),' Commissioner of Inland Revenue v. Smythe [1981] 1 NZLR 673 (C.A.).

7A We think that there are circumstances where the substance of a transaction will diner from the legal form, and where reflecting the substance of the transaction in the financial statements is necessary in order to give a true and fair view. It is implicit in this circumstance that reflecting the form of the transaction or the legal relationship alone will not result in a true and fair view. While we prefer the view that a contract should normally be reported as it is, because it is the contract that is definitive of the rights and obligations of the report/fig entity, we acknowledge that there may be circumstances where, because of the "true and fair" override, the substance of the transaction perceived by the accountant and auditor should be reported in the financial statements. In these circumstances, a note should disclose the terms of the contract and the full enact of the departure form reporting the legal form in the financial statements. Where possible, that enact should be quantified and disclosed.

15.21 Trow, in his 1988 paper referred to at para 10.2 said:

> ***The precedence of substance over form is fundamental to true and fair report/.ng. /f directors can successfully argue legal form as the basis for report/`ng we will certainly be facing up to a crisis of the most serious kind.***

15.22 In a written statement in evidence to the Commission Trow commented:

> ***34.*** ***The direction that is provided in FASB Statement 5 is an application of one of the background guidelines for accountants when selecting accounting procedures. The guideline (as set out in SSAP 1) is that transactions should be accounted for in accordance with their substance, that is their financial and economic reality, and not necessarily in accordance with their legal form.***
>
> *35.* ***In practice, however, it is not always an easy matter to decide when a particular legal form should be overlooked and the circumstance presented in financial statements in a substantially different way. Judgment needs to be exercised and the decision on the fairest presentation may be difficult. Lawyers in particular can be strident advocates for the "correctness- of legal form when directors, accountants and auditors may be giving consideration to recording the event in a different manner.***
>
> ***36. It must be explained also, that the accountant's attitudes and practice on matters of substance over form have evolved only gradually In recent years. During the latter part of the 19808 a number of off balance sheet Items and artificial schemes were recorded in accordance with the legal form. The introduction of a new accounting standard on business combinations at the end of the 19808 together with a better understanding of these circumstances had helped to bn.ng about a noticeable and recent change in attitude to the recording and presentation of such terms.***
>
> *37. The United Kingdom has had an exposure draft on -Accounting for special purpose transactions" on issue for over three years and it is only now that the UK profession is close to issuing a definitive standard on the topic. This exposure draft covers a variety of topics on the issue of substance over legal form, but does not cover the topic of insurance arrangements.*

IS.23 Hays, in giving evidence, commented on the 'emerging accounting recognition. of substance over form at p.82, 2nd hearing:

> ***It would need to be recognised that issue was emerging and I think where it got to, when I saw the [Commission's consultative draft] report is here as at 1990 the particular issue had not developed strongly enough and it didn't really emerge stronger until 1991 at which time the Coopers & Lybrand report had come along***

and at p.91/92:

> ***I 've tried to put myself back Into a position of 1988 through to 1990 and say as an accountant we would have accepted that there was an insurance policy. Today, I consider with the knowledge of today and I would say no It was a financial Instrument and had a different form of accounting for it. From an accounting viewpoint its proper accounting treatment.***

15.24 **Hickey commented to us about the issue of 'substance over form.' She said at p.536:**

> *The substance over form notion ....was known and acknowledged in 1988 and referred to in SSAP-1. ... I have to say however, and I think this will become clear in terms of the accounting pronouncements that for an arrangement like this, an insurance arrangement, it did not surprise me when I first looked at It In 1990 to find that It had been accounted for on the basis of being an insurance arrangement and applying the matching principle.*
>
> ***Why was I not surprised by that? First of all there were no New Zealand accounting standards. There are none cunently, there were none then ... New Zea/and SSAP-1 is a standard which primarily requires disclosure of the accounting policies that have been adopted by an entity. In its Discussion Section rather than its Standards Section it does provide some guidance in determining most appropriate accounting policy. One of the criteria it gives is the substance over form criteria ... Other criteria that are listed, and there 's no particular weighting given to one criteria over another, are relevance to users, consistency over time, and prudence or conservatism.***

15.25 **We have considered these comments. We do not accept the submission that the concept of substance over form was only emerging in New Zealand accounting thought in the early 19908. We believe it was well established considerably earlier than that. We have reviewed accounting literature in the**

19808 for references to the concept of substance over form. We have set out further references to "substance over form" in Appendix L to this Report.

IS.28 **RWS, in submissions for E & Y in a loner dated 4 May 1993, noted that, for the purpose of determining the appropriate accounting treatment for a particular transaction:**

> *The key factor is that in determining the economic substance of a transaction, one must start with the legal form In order to determine the nature and extent of relationships that have been established. The point was made by* ***Richardson, J*** *in* *Marac Life Assurance Ltd v. Commissioner of Inland Revenue* *[1986] 1 NZLR 694 in a passage cited with approval by Hill, J in the* *NM Superannuation Pty Ltd v Young* *[Federal Court of Australia, South Australia District Registry (No SG 41 of 1992, 12 March 1993)] Judgment:*
>
> > ***...*** *what is crucial is the ascertainment of the legal rights and duties which are actually created by the transaction "Info which the parties entered. ,*
>
> *Having regard to those rights and duties, the accountant is then required to step back and consider whether there Is an economic result which, because of some other reason or arrangement, diners from the result which the parties have created at law.*

18.27 **We agree with RWS. In doing so we note their caution that:**

> *...the determination of the economic substance of a transaction Is often a matter about which people of principle and good intention can disagree. It is also a matter on which the views of an Individual, or a profession, can change over time.*

IS.28 **Economic substance should over-ride form where to follow legal form may impair the truth and fairness of the results of an entity or its state of affairs, that is, may obscure financial and economic reality.**

18.29 **While the arrangements wore the clothes of an insurance contract they did not involve the transfer of any insurance risk and the Bank's return was related solely to the interest yield on the investment of the premium. The attitude taken by the October 1988 Board, and the caution expressed by E & Y's senior audit partner, Macaulay, when first acquainted with the arrangements (see para 4.9), suggests their substance was well understood from the beginning.**

IS.30 **We conclude that the arrangements were not accounted for in accordance with their economic substance in the year ended 31 March 1990. In our view they should have been.**

(c) Consistency of application of accounting policies

IS.31 **The third of the *Important criteria* which should be considered in selecting appropriate particular accounting policies is the consistency of the application of accounting policies over time. SSAP-1 says:**

> ***Consistency. Particular*** *accounting policies adopted by an entity should normally be consistent from one pen'ad to another, and should be applied to all items of a similar nature. However, consistency, in itself, should not be used as an argument for the retention of a* ***particular*** *accounting policy which is no longer appropriate.* [Original emphasis}

IS.32 **The criterion of consistency appears to have been recognised by the Bank. In the draft minutes of the Audit sub-committee meeting of May 11 1990:**

> *The loss Insurance claim of $100 million has been dealt with in two parts. Firstly by way of an offset of $40 million against the annual premium cost of $22 mi//ion and lack of interest income of $18 million. This has had the enact of increasing the operating profit before provisions and tax by $40 mil/ion. Secondly, by a reduction in the requirement for provision for doubtful debts by $60 mi//ion.*
>
> ***In this years audit review Ernst & Young have uti/isad their senior technical***

partner, Liz Hickey, with a full review of all the Bank's accounting policies and practices Including this policy. Ms Hickey indicated that the accounting treatment which was agreed by the auditors In financial year ending 1988 may not now be in line with emerging and developing accounting practices.

In reviewing these comments the directors noted there Is now variance on this matter and they consider it is appropriate to maintain a consistent treatment for this policy.

15.33 In order to test the logic and relevance of the phrase-maintain a consistent treatment for this policy` we have prepared the following summary of the accounting treatment given to the insurance arrangement on each successive annual balance date until 31 March 1990.

Year ended 31 March 1988

One day's premium charged against income

Year ended 31 March 1989

$40 million in benefits claimed. All this amount deducted from provision for doubtful debts.

$22 million premium charged to -other operating expenses-.

Year ended 31 March 1990

$94 mu\ion in benefits taken, of which:

$54 million is deducted from the provision for doubtful debts:

$22 million is offset against other operating expenses;

$18 million is added to operating income.

$22 million of premium is amortised to other operating expenses.

15.34 Lojkine, together with Pearson, guided the Board of October 1988 in the determination of an appropriate accounting policy and established a level of

"claims" for ensuring that the Bank did not overstate its income in that accounting period.

15.35 The Board's accounting policy was described by Stockwell in his memorandum of 2 May 1989 (see para 14.14):

> *Claims on the scheme have been limited to date to the amount of accrued annual premium and funding opportunity cost resulting In a neutral profit and loss position.*

15.36 We consider the Bank's original policy was to match revenues with expenses. $40 million in benefits under the arrangements was recognised as income for the year ended 31 March 1989, matched with:

The annual premium (1/5 of $IIOm)	$22m
One-fifth of the interest accruing on the bonds over 5 years ($90m)	$18m_
	$40m_

15.37 With the use of the more precise YTM calculation the Bank would have recognised interest at the lesser figure of $15 million. However the $3 million overstatement of income which resulted is not material in this context, and the policy followed by the Board was acceptable.

15.38 Whereas the $40 million benefit was deducted from the doubtful debts provision, the use of YTM would have applied the $37 million:

Reversal of the premium	$22m
interest income	$15m_
	$37m

15.39 It is thus necessary to compare the above approach, also reflected in the ha\-yearly statements to 30 September 1988 and 30 September 1989, with the approach followed for the 1990 financial statements.

15.40 In our opinion, the decision to recognise income of $94 million, $55 million in excess of the "matching expenses', was a departure from the policy followed in the three preceding accounting periods when the recording of income was limited to the equivalent of the premium and interest "foregone' on the **investment of the premium.**

15.41 The claim of consistency is further eroded by the way in which the claim was reflected in the 1990 financial statements (see para 15.33).

15.42 **Our conclusions** are:

(a) **The policy formulated by the 1988 Board was based on the conviction that future income should not be anticipated or reported** as income in periods earlier than those in which that income would be derived;

(b) The change in 1990 was a major departure from that policy;

(c) We do not consider that the approach adopted in the Bank's 1990 financial statements was consistent with that followed in 1988 or 1989. In our view, the approach in 1990 represented a major change in accounting policy involving consistency.

(d) Prudence_

15.43 The fourth of the *important criten`a* which should be considered in selecting the most appropriate particular accounting policy for a transaction is prudence.

SSAP-1 says:

> ***Prudence. The uncertainties which surround many business transactions should be recognised by the application of prudence In the selection of the particular accounting policies to be used.***

15.44 **We have noted that the Bank's treatment of the arrangements involved the recognition of income in advance of the time when it had been earned In our view this is not prudent.**

15.45 **Prudence was in the minds of the directors of the Bank in October 1988. Lojkine, when asked for her views on the recognition of claims made in advance of the ability, or the obligation, of the insurer to pay out those claims, said at p.955:**

> ***What would have weighed more with me would be the enact on the profit and loss account in a way that I don't think would have been correct. But it did come up as you know in relation to the half-yearly accounts In the 1988/89 year and there was a bit of an argument about it so it was probably also evident because the Bank wanted to bring back more than had bean set aside in the first half-year.***

15.48 **We asked Lojkine to comment on the Bank's use of the arrangements in 1990. She advised us, in a memorandum of 8 February 1993:**

> ***...in my view, this was technically untenable. To exceed this figure [the sum of the premium and the Interest accrued to that date} means that income has been anticipated, and both assets and shareholders' funds are overstated in the balance sheet.***

(e) Evidence of substantial authoritative support

15.47 **We noted earlier that, in terms of Auditing Guideline No 2, any accounting policies which are not the subject of specific SSAPs are required to be appropriate to the entity and have substantial authoritative support.**

IS.48 **In the case of the Bank's accounting for the arrangements we have not found any authoritative support for the Bank's accounting policy. We have identified the American standards FASB-S and FASB-97, both of which were issued before March 1988, which appear directly relevant to the point. The Bank did not follow the guidance of those standards. We now proceed to deal with this question.**

IS.49 We observed at the beginning of section 10 that in 1988 Trow had listed US standards as a source of accounting authority. We received several submissions on this issue.

16.60 Trow submitted, after quoting from FASB S referred to by Coopers and set out in paragraph 10.12):

> 32. *There is no other known reference in accounting standards in any other country in the world relating to this topic.- It is interesting, in this instance, that the matter is covered in an appendix to e statement that is not directly concerned with topics such as insurance schemes. ... In these circumstances, an accountant might be excused for falling to appreciate that the topic had been covered in one of the accounting standard publications.*
>
> 33. ***It should also be resit.sad that from before 1988 up to the present day there have been a number of accounting practices that have been generally accepted in New Zealand but contrary to the standards of the United States. There is no requirement for New Zealand accountants to follow US standards when preparing financial statements on the local scene, although the US standards can be seen as a useful source of authority when unusual circumstances are encountered.***
>
> 38. *In the early part of the 1980's It was accepted practice in the Insurance industry in the United Kingdom, for companies to record arrangements similar to the BNZ credit insurance as Insurance schemes, when amounts were placed on deposit as reinsurance premiums and these were designed to smooth the impact of insurance losses over an extended period of time.*

39. *The arrangements for the Insurance companies were stopped when scandals on the misappropriation of the deposits were revealed The accounting presentation of such arrangements as insurance schemes has been accepted practice in the UK. I notice that in December 1991, however, the Institute of Chartered Accountants of England and Wales issued a discussion paper on Accounting for reinsurance transactions that indicates that, in circumstances such as those now under review, it is considered appropriate that the arrangement should be recorded as an interest bearing deposit. Now we are seeing some instances of the arrangements in the banking sector (e.g. Pan.bus in France) and I understand that the arrangements are currently being marketed in the banking sector in additional countn`es.*

40. *In view of these comments, the conclusion to be reached is that at the time of the commencement of the arrangement In 1988, it would be apparent that the accounting procedures that were proposed were within the bounds of the generally accepted accounting practice of the time.*

41. *In other words, it was reasonable and understandable for the BNZ to have given favourable consideration to the proposed accounting for the insurance arrangements as outlined in 1988. As has been noted, however, the BNZ adopted the proposed arrangement and associated profit smoothing to only a limited extent. ....*

[* Trow does not refer to FASS 97 in this context}

15.51 Hays, in a loner submitted on behalf of a number of former directors of the Bank, said:

1.4 *Reference has been made .... to an example set out in an Appendix to FASB 5 -Accounting for Contingencies-, which had been in effect in the USA since 1975. The example cannot be considered to represent generally accepted accounting practice in New Zea/and. The NewZealand Society of Accountants, when reviewing overseas precedents, looks primarily at the standards issued by the International Accounting Standards Committee, the Australian standard setting bodies, and the UKprofession. If those bodies in their standards dealing with accounting for contingencies have not excluded from the definib.on of contingent liabilities the risks associated with investment insurance contracts, then there would be no basis for contemplating an example which make the exclusions but was contained in an explanatory appendix to a US*

financial reporting statement, being effective as generally accepted accounting practice In New Zealand. ...

1.5 *It was not until 1990* that the FAS8-105 "Disclosure of Information about Financial Instruments with OH 8alance Sheet Risk and Financial Instruments with Concentration of Credit Risk" became effective in the USA.' In 1991 when the International Accounting Standards Committee issued a draft proposed statement ED-40 "Financial Instruments", and February 1992 when the N.Z. Society of Accountants released its exposure draft ED-66 "Disclosure of Information about Financial Instruments". The effect of these standards and proposed standards Is to support the reporting of the substance of the transactions over their legal form.*

1.6 *However, back In March 1988 with many innovative financial arrangements being entered into, which often blurred the once relatively distinct lines between different types of financial arrangements, it was believed that if these were reported according to their legal form, then a true and fair view would be given as required by the Companies Act 1955. ....*

and, after referring to the Commission's 1989 publication `Capital Structure and Financial Reporting in New Zealand', which we referred to earlier, he said:

1.9 *To summarlse, in my view the treatment of the arrangement as an insurance policy by the prior board of the 8NZ in that bank's 31 March 1988 financial statements was likely to be reasonable and within the limits of generally accepted accounting practice In New Zealand at that time.*

In these circumstances there would have been a considerable range of tolerance within which the 8NZ was able to offset future bad debt losses it incurred and hence were claimable under the policy, with recoveries available to it in accordance with the policy.

[*Hays does not mention UK ED42, "Accounting for Special Purpose Transactions", which was issued in March 1988 and dealt extensively with accounting according to the substance)

15.52 Writing in April 1991 the authors of the paper Financial Reinsurance - A Discussion Paper, which *we* have already ready referred to in para 5.19, state:

> ***While the accounting profession has bunt up over the years a number of general principles and practices there is, as yet, !idle in the way of accounting standards that assist auditors in determining how to handle financial reinsurance contracts. Until recently accountants and auditors had accepted, without looking at the substance of the Individual policies, that financial reinsurance contracts should be treated the same as any other reinsurance policy. They are now beginning to look at the substance of the contracts.***

and further state:

> ***While reinsurance provides a legitimate mechanism for risk transfer, few In the accounting profession would maintain that, In principle, insurance company results should be completely smoothed by the transfer of losses between reporting years or that reinsurance contracts should be able to be used to disguise the financial viability of an insurer.***
>
> ***Accounting authorities on both sides of the Atlantic Ocean have recently been considering financial reinsurance with a view to prescribing key elements which must be present before a contract can qualify as a reinsurance contract. While discussion papers have been Issued in both the USA and the UK, mandatory arrangements have yet to be laid down In those countries.***
>
> ***In both the UK and USA author/Ties hold the view that, where there is no transfer of insurance n.sk, financial reinsurance should be accounted for as if it were a financing arrangement and not as a reinsurance contract.***

15.53 RWS, for E & Y, have submitted:

> ***6.4*** *Both Mr Macaulay and Mr Gerty were of the opinion that In accordance with the accounting standards of the time, the arrangements were properly dealt with In accordance with the matching principle. There were at the time no applicable accounting standards or practices which required them to treat the transaction In the 1990 accounts otherwise. ....*
>
> ***8.4*** *The only accounting authon.ty which* ***arguably*** *indicated that the arrangements should be treated as a deposit at the relevant time was an explanatory note to an Amen'can accounting standard dealing with contingencies which ..... if it were on the point would* ***not be binding In New Zealand***
>
> [Original emphasis}

15.54 **Mr J. Chin of Coopers, referring to the work which had been done for the Operational Review Committee, said at p.555:**

> ***We have quoted Financial Accounting Standard No 5 issued by the United States Financial Accounting Standards Board I think it is which specifically refers to transactions which may not Involve the transfer of insurance risk. We believe that provided us with authoritative support for our view.***

15.55 **Chin was asked if he would have come to a different view if Coopers had been carrying out the Operational Review in 1988 instead of 1991. He said at p557:**

> ***I guess its very much a hypothetical question but bear In mind that in the mid 80s certainly leading up to the sharemarket crash there were a lot of accounting policies adopted by a lot of entities which were deemed to be appropriate which probably nowin hindsight people believe is inappropriate. It Is difficult for me to say, to cast my mind back to that environment and then say if [/] was looking at this transaction at that time I would have said that this transaction was categorically inappropriate or otherwise. I guess the only substantive comment I can make is that the authoritative source that we have cited was issued prior to 1988 but I would also counter that by saying that at that time a lot of companies and perhaps accountants didn't pay that much reliance to overseas accounting standards. 1 believe that focus has now changed but seeing that at that time there was a clear focus on New Zealand accounting standards and to the extent that there was no New Zea/and accounting standards specifically addressing the transaction which I understand was the case at that time, addressing this transaction at that time, there may have been a bit of leeway In adopting an alternative treatment.***

15.56 **We draw attention to an article in the December 1986 <u>Accountants Journal,</u> "Creative Accounting - Quo Vadis. by Don Christiansen, then senior partner with Peat Marwick Mitchell and Co. He said:**

> ***To best serve company shareholders In particular and society in general a public company auditor must keep two thoughts uppermost - the first is the need to keep an open mind In reaching an opinion,- the second is the need to preserve the authority of his audit report.***
>
> ***The current wave of so-called "creative accounting" makes both these aims very difficult.***

Not surprisingly company directors are under very great pressure to present information, particularly performance type information, In the best possible light.

and

An auditor must am.ve at an open-minded purely judgmental decision whether the accounting is "true and fair. This can be hard in a fast moving commercial environment, particularly as creative accounting techniques nearly always involve issues of the substance of the arrangement over the form Of *It - ......*

To help the auditor make his or her decision an auditor needs standards. The modem auditor is lost without Standards. ...

and

Unfortunately the Standard Boding process Is slow and cannot keep pace with the rate of change. Though auditors have great respect for what has been achieved In New Zealand by practitioners in their spare time and the limited research facilities of the Society of Accountants, the fact Is that It has taken too long to deal with major issues needing standards. In practice auditors have tended to fill the gaps by reference to the Standards of other countn'es, particularly the FASB in the USA.

15.57 While US standards were not directly binding on members of the New Zealand Society of Accountants ('NZSA`) in March 1988 (a situation which is changing as Parliament and the NZSA move to define the term "generally accepted accounting practices" in the New Zealand context), and the reference to FASB 5 may not have been well known, nonetheless the guidance is directly on the point.

15.58 **Paragraphs 44 and 45 of FASB 5, indicate that, as far back as 1975, the existence of certain financial arrangements, purporting to be insurance policies, was the cause of sufficient concern to compel the FASB of the United States of America to issue a very clear statement which both identified the elements of the offending arrangements and the appropriate accounting treatment. The Bank's arrangement is of the variety addressed in FASB-5.**

15.59 **It is apparent that financial reinsurance is a type of contract which has been used in the general insurance industry. It would appear that one of the main objectives of its use is to achieve a discounting of future liabilities where the regulatory authorities would not permit such discounting for the purpose of calculation of statutory reserves. It is acknowledged that one of the objectives of financial reinsurance is to smooth the reported profits of the reinsured. It would appear that accounting and regulatory authorities have been working to develop accounting guidance to overcome the mis-reporting of such insurance contracts.**

15.60 **In the present case we are dealing with a bank not an insurance company. We can find no authoritative source of support for the Bank's accounting treatment of the arrangements. We do not regard the questionable reporting practices of certain insurance companies in other countries as providing authoritative support for the Bank's accounting policy in New Zealand. We do not accept the submissions of Trow and Hays that the accounting practice followed by the Bank in March 1990 was within the bounds of generally accepted accounting practice of the time.**

15.61 **On the contrary FASB 5, whether seen by the Bank or not at the time, was sufficiently authoritative in 1988 and 1990 for us to consider that the accounting practice followed by the Bank in March 1990 did not have authoritative support.**

Conclusion

15.62 **We conclude that the accounting practice followed by the Bank in 1990: did not accord with the Bank's own general accounting policy of matching revenues and expenses; did not account for the economic substance of the arrangements when it should have; departed from the accounting policy consistently applied in the three preceding reporting periods; was not prudent; and did not have authoritative support or come within the bounds of generally accepted accounting practice.**

C. Materiality of Misstatements in the Bank"s financial statements

15.63 **The next issue to determine is whether the distortion to the Bank's pro-tax income resulting from the Bank's use of its inappropriate accounting treatment for the arrangements was material.**

15.64 **The Bank's use of the arrangements in the year ended 31 March 1990 resulted in an increase in the BNZ's pre-tax profit of $55 million. With total pre-tax profit of $100 million this influence appears material. We now proceed to examine the records of the Bank, the views of directors, the advice available to directors, and submissions made on their behalf.**

(a) The records of the Bank

15.65 The Board of the Bank final|sad its March 1990 financial statements at a meeting on 21 May 1990. The Board received extensive documentation for this purpose prepared by the Bank's Chief Financial OHicer, Mr D.C. Shelton.

15.66 **Mr D.G.Sadler, then chairman of the Board's Audit and Finance Sub Committee, wrote a memorandum to the full Board of the Bank dated 17 May 1990. In that memorandum he noted:**

The draft accounts (assuming no change to Provisions requirements following audit completion of Australian branch) have been made available and show an after tax profit for the year (before extraordinaries) Of $126 million (second half $75 million).

However this improved result has been affected by a number of abnormal items of which two are not currently identified in the proposed notes being the use of the credit insurance proceeds as to $100 million and the (correct) recognition Of perpetual notes surplus Of $32 million.

Analysts and media writers using a mechanistic procedure would calculate the second half results as shown in Appendix !. Notes of abnormal amounts new items compared to the first half are shown as notes.

Therefore if analysts said let us strip our the abnormal items and the changes in policy/practice as at that appeared in the second half (assuming that we did disclose items 5-8 inclusive as shown in Appendix !) they would come up with second half results hence trends as shown in Appendix !I.

Further directors would have increased difficulty in justifying recognition of tax credits unless there is a substantial injection of capital - the stage three results shown .... include $400M of new capital and this is likely to be around the minimum quantum necessary to restore reasonable earnings which would allow us to recognise future tax benefits Of the proposed magnitude.

The results indicate the size of the turnaround job still remaining which should not be surprising - e.g. Bank of America, Mellon Bank.

Dividends for 1989/90 are in my view diHicult to support.

[Original emphasis}

15.67 Appendix I of Sadler's analysis, when referring to the use of the arrangements, states:

6. *[Interest Margin} Includes $18M use of credit insurance being compensation for lass Of income on deferred cash proceeds. Not disclosed in the accounts or notes.*

7. *[Expenses] Includes credit of $22M to onset cost of credit insurance premium. Not disclosed In the accounts or notes.*

[Provisions] Includes offset of $60M credit insurance. Not disclosed in the accounts or notes.

15.68 **Appendix II referred to by Sadist shows that, if analysts separated out the abnormal items and changes in policy/practice, the Bank's results might be seen to be:**

($Mi//lons)	***30.9.89 6 months***	*31.3.90 6 mOnths*	*1989/90 12 months*
Interest income	*232*	**185**	*417*
Operating income (other)	*231*	***206***	*437*
Net Income	*463*	***391***	*854*
Expenses	*346*	***35***	*697*
		0	
PST & Proms	*117*		*157*
Provisions	*98*	*41*	*251*
		153	
PST	***18***		*(94)*
Tax	***(33)***	*(112)*	*(85)*
PAT before minorities	*51*	*(60)*	*[(9)]*
Extraords Pref Shares dividends			***3***

15.69 The minutes (headed.Draft') of an Audit Subcommittee meeting held on 11 May 1990, also included in the papers considered by the directors at their Board meeting on 21 May 1990, incorporated more extensive references to the use of the arrangements. These references include:

4. ***.The loss Insurance claim of $100 million has been dealt with in two parts. Firstly by way of an onset of $40 million against the annual premium cost of $22 million and lack of Interest Income of $18 million. This has had the effect of Increasing the operating profit***

before provisions and tax by $40 mi//ion. Secondly, by a reduction in the requirement for provision for doubtful debts by $6Om.

9. ***Provisioning for specific and genera/ doubtful debts.***

The draft accounts included in the profit and loss statement a transfer of [$166.4 m] to specific and genera/ provisions. This comprised transfer to specific provisions of $214.8 and a write back from genera/ of $48.4m. The specific provisioning in 1990 does not include amounts for various debts totally $60 mi//ion which have been indemnified under the debt insurance policy. The /eve/ of specific provisioning has been reconciled to the BAH [Booz Al\en Ham\\ton} review as follows..

	$000
Specific provision balance	901,688
BNZ Finance	81688
Sub total	893, 000
Plus late write-ons of Specific Provisions	1071000
Sub-total	1,000000
Plus not balance held in loss insurance IOOzOOO	
BAH recommendation	IzIOOzOOO

The directors having reviewed the recommendations from Group Credit and Booz Allen are satisfied with the recommendation with regards specific provisioning. On genera/ provisioning there Is a range of scenarios for Australia and NewZealand based on various economic forecasts. The draft accounts Included a balance of genera/ provision tote/ling $288.Sm including BNZ Finance. This balance was within the upper and lower extremes of the BAH recommendations and directors decided to take an even more conservative approach and transfer an additional $25m to genera/ provisions.

Mr Garty was supportive of the directors approach which was in line with their estimates. He has agreed with all provisioning In New Zea/and [and] with the genera/ provision. However [he] will be visiting Australia next week to review their specific provisioning.

Later, after Garty is recorded as having joined the meeting, it is noted:

> *2. General Provisions.*
>
> *Mr Gerty admitted that the directors actioning* [sic] *increasing the provision was more in line with their estimate.*

15.70 The minutes of the Board meeting of 21 May 1990 record that the Board considered Sadler's analysis (see paragraphs 15.67 and 15.68 above) and decided:

> *Items Six to Eight are intertwined. It was resolved that the onset of $60m credit insurance should be reduced to $54 mHllon,' and disclosure in accounts or notes is not required, as the amount should be seen in relation to the $1,217,288,000 Specific and General Provisions and is hence not material.*

15.71 We observed that the directors of the Bank had measured the impact of the use of the arrangements only against the balance sheet figure for overall provisions, without apparently considering the impact on the Bank's reported profits. This did not appear to accord with SSAP 6.

15.72 We observed that the directors were aware that full disclosure Of the "abnormal items" and .policy/practice changes' could lead analysts to the conclusion that if profitability was calculated on a comparable basis to the previous year, (but, we note, without any benefits being taken under the arrangements), the Bank would show a pre-tax loss for the year ended 31 March 1990 of $94 million.

15.73 We questioned a number of directors on the Bank's use of the arrangements in 1990.

(b) Evidence qiven by directors of the Bank

15.74 It was put to Sadler that the additional benefit of $55 million, recognised as income in the March 1990 accounts, represented improper use of the arrangements, and that acceptance of that view would have resulted In a reduction of $55 million in the Bank's annual profit before tax. Sadler resisted the suggestion by responding that the Bank could have lowered the general provisioning as an alternative thereby leaving the original profit before tax undisturbed. He told us at p.203:

> ***I reject the suggestion ... that the audit committee's analysis did not accord with SSAP 6. Because the insurance claim was an optional component of provisioning It had no effect on the Bank's profit hence the /eve/ of shareholders' funds. Likewise I reject and take strong except/on to the suggest/on ... that the 1990 financial accounts were Incorrect** In a **fundamental respect.***

15.75 Sadler was asked to comment if the arrangements were an income smoothing device. He responded at p.216:

> ***No because you would not have made the same /eve/ of provisions. It was in the directors' hands to make & judgment on /eve/ of provisioning required at a certain time and that was forward looking. It was always going to be something that was a best est/mate so If you used that credit Insurance in gO rather than in 91 and 92 then you real/sod that there was going to be some impact on provisioning In that period but the amount that you provided at any particular point is one and a half billion dollars. You wouldn't be certain If that was going to result in income smoothing or not.***

15 76 Referred later to the possible impact on the profit and loss account of the use of the arrangements Sadler said at p.245:

> ***Only if you have then said right oh we stay with the provisioning figure, we don't reduce the provisioning figure and therefore the non-taking of credit insurance will result In a lower profit. I am saying that If the credit***

insurance had not been taken then almost certainly you would have relocked at the provisioning figure and been able to easily argue you know not just 50 million a hundred, two hundred million.

15.77 **Sadler is also recorded as having said, in the minutes of a meeting of the Operational Review Committee held on 13 March 1991, referring to the arrangements:**

David Sad/Br commented that it had been adopted prior to his appointment to the Board but that he had always seen it as an income smoothing device.

When asked whether this was still his view Sadler said at p.219:

Yes but it wouldn't have had to be used.

15.78 Congreve said to us at p.1257:

...I saw this and I still see it In the context of the Bank 's provisioning and it was, / saw It and I still see It as a mechanism that the Bank put in place [for] quite proper purposes as a part of /ts provisioning...

15.79 **When asked to comment on the transparency of any adjustments made to general and specific provisioning, when compared to the use of the arrangements, Congreve said at p.1358:**

Well, all / can say to the Commission is to repeat that I viewed this as being a valid insurance policy which enabled the Bank to make a claim which In the year 1990 enabled It to make a claim to augment very significant provisions of approaching` as I recall $170/180 mu/Ion to augment or to In conjunction with the claim that was made against general provisions also In that year and that, that decision was made in the context of a billion dollars of specific provisions and $300 million of genera/ provisions which were available to the Bank at that time which was nearly 2% of the Bank's at riskpcrtfollo which was regarded as being a very large genera/ provision.

and at p.1364:

> ***...If Ibo three alternatives [Increase In specific provisioning, lowering the genera/ provision, and use of the arrangements} hadn't been open to us, / am quite clear In my mind that what we would have done Is we would have charged more to the genera/ provision. As It was, ..., we had the Insurance policy open to us, we had another string to our bow If you will, which enabled us to keep a bit more of the genera/ provision up our sleeves, which It was for because obviously at that period which was post March 1990 we were becoming aware that all was not we// In Australia..***

and, also at p.1364:

> ***I feel its Important that my position on this be recorded. Firstly that It was an Insurance policy and secondly that It was used In the context of genera/ provisioning at the point of Urns when we felt that we were very, very adequately provided for In the genera/ provision.***

15.80 **Pyne, when asked to explain his understanding of the arrangements, said at p.1496:**

> ***...my understanding of the policy was that It was there as a contingency for an additional component of provisioning that one could use. Certainly / had not, no one had voiced to me for It to be anything different than that and why we had not required It In 1989 [was] because of the provisioning we had done. In 1990 we thought It was appropn.ate to use It.***

and at p.1511:

> ***...It Is /nexIn.cab/y linked with provisioning. It Is no more, no loss than provisioning***

15.81 Questioned concerning the impact of the Bank's use of the arrangements on the Bank's disclosed profitability Pyne said at p.1581:

> ***/ am saying that the genera/ provision was of such a magnitude that it was quite excessive. This Is what the banks had done In the past and that's 1% of all debt, It was something Ilka 2% so any potential provisioning that we put to the Insurance policy could have been put through the general. We had Ibo policy and that's why we used It.***

and at p.1582:

> *...in using It, it allowed us to keep the genera/ provision at its current /eve/ which gave us even more support or more buffer in terms of any potential that might have come out of the non-performing debt that we were getting concerned about.*

15.82 Fay was asked if he agreed that the use of the policy had had a significant impact on the Bank's profits in 1990. He responded at p.1719:

> *No, no I wouldn't agree. I don't think it was, I think you 've got to see the exercise in provisioning at large and the Bank was facing substantial provisioning that year, we had the capacity In my mind as a director to look at the insurance policy, the genera/ provisioning and then specific provisioning Now to the extent that you have to make a judgment as to how much specific provisioning you do, how much genera/ you will use, then you, yes, you do or don't have an impact on the profit and loss. Specific provisioning does, the genera/ provision doesn't, and I saw the insurance policy as part of the genera/ provisioning exercise.*

and at p.1721:

> *...we had three things available to us In that year, we had the Insurance policy, we had the genera/ provision which was, as I recall, quite large that year, nearly 2% of the risk weighted or adjusted balance sheet of the Bank, and then specific provisioning...*

and at p.1739

> *I think my persona/ view as a director at the time was that we were being conservative In taking in keeping using the capacity we had the insurance policy and the genera/ plus specific and keeping the genera/ provision high, higher than perhaps you would need to given the amount of specific provisioning we were doing, more due to the fact that we didn 't really know and I don't think any banks knew, Australia was a question mark at that time in the Board's mind.*

IS.S3 On the questions of materiality and disclosure Fay said at p.1739:

> ***...1 do recall that there was some discussion as to materiality which I suppose would Impact on your view of disclosure to the extent it was material, ... and I think we did have a netting off, a sort of an overs and unders arrangement which did Include the net pretax enact of using $54 of the provision to the insurance policy against it. There was some genera/ adjustment that year, It wasn't big. $30 million odd 1 think.***

(c) Evidence from the Bank's Chief Financial Officer

IS.S4 Shelton, the Bank's Chief Financial Officer in 1990, was asked if he agreed the arrangements did not involve the transfer of insurance risk. He replied in the affirmative. He was asked for his views of the arrangement. He said at p.944;

> ***I thought the transaction was a strange one in the first instance and I sought to see whether we could unwind It at any stage but 1 was told that we couldn 't...***

Shelton agreed that the arrangements should be accounted for on a YTM basls.

IS.SS **With respect to the planned usage to be made of the arrangements** in **1990 Shelton was asked if the Bank was looking to achieve a particular -bottom-line- result. Shelton said that this was the case.**

IS.S6 **Asked his view on the way the Bank used the arrangements in 1990 he said** at p.947:

> ***Taken in isolation I wasn't very enamoured with It but I recognise In the overall accounts that there were offsetting Items as alluded to In the unders and overs schedules.***

(d) Submissions on materiality

15.87 **Hays was asked whether the overstatement of profit for the 1990 income year was material. He said at p.99, 2nd hearings:**

> ***If I might first qualify my remarks In that I've not examined the financial reports of the Bank of New Zea/and for the years. /'ve not had the time and I've merely a summary of the key figures extracted from those accounts so subject to that you know / do observe that the profits of 1987 of a certain amount went up In 1988 and then plunged to a massive loss in 89. Then in 1990 It restored to profit but not to the levels of the 87 and 88 years. My assessment in those circumstances would be that $54 mil/ion for 1990 was not material.***

and at p.104, 2nd hearings:

> ***To me the user of the reported accounts In 1990 would make much the same decision on those accounts whether the profit was $50 ml//ion lower than the figure reported or 50 mil/ion dollars higher. It showed whichever number one had eventually there / think would show the same result. There had been a recovery from 1990 but it was a still a long way short of what had been achieved In 87 and 88 and that's why / believe that the amount referred to In the report for an adjustment for 1990 is not material when you look at the affairs of the Bank of New Zea/and.***

and at p.105, 2nd hearings:

> *The way I would see It Is that the user of the accounts and / think we'd generally be talking here in terms of the shareholders as the users would have seen after a disastrous year In 1989 that the bank had recovered a great deal. It was not now reporting a result as bad as 1989. It was reporting a profit but a profit which was not large in relation to what had been achieved in the years Immediately before 1990 and that's why / would see that the user of the accounts would look at that reported result' in relation to the actual results of 87 and 88 and if materiality was to be a factor then that would have also be assessed In relation to the results 0187 and 88.*

IS.88 Trow's view, at p.22/23, 2nd hearings, was:

> *I would not include the Impact of the Insurance arrangements In the alleged over-statement, because the accounting treatment Is within the generally accepted practice of the time.*

IS.89 We note, however, that in a 1991 paper presented to a New Zealand Law Society Seminar on Auditors' Liability, by Trow and Rhys Harrison, the authors said:

> *If the distortion is more than 10% of Net Income and the client will not modlfY the financial statements, the auditor will prepare an "except for" opinion i.e. the opinion would be that, except for the Item in dispute, which Is quantified, the financial statements present a true and fair view. A distortion of around 50% or more would probably lead to an adverse opinion i.e. the opinion would be that the financial statements do not present a true and fair view. The decision on whether, and at what level, to issue an except for opinion or adverse opinion Is a matter of judgment for the auditor concerned.*

(e) Our view

16.90 The directors of the Bank submitted that the influence of the Bank's use of the arrangements in the year ended 31 March 1990 was immaterial because, if the Bank had not used the benefits under the arrangements to the extent that it did, it would have simply lowered its then general provision by more than it did.

16.91 We accept that in a financial institution the size of the BNZ the task of determining the appropriate level of doubtful debt provisioning is difficult. Complex judgments are involved. However, the Bank, from 1989, employed outside consultants who devised and implemented a classification system for the Bank's exposures. Through the use of this system appropriate levels of general and specific provisions were identified, although always still subject to the directors' judgment at the end of the day. The auditors conducted their own

classification exercise and came to their own conclusions about an appropriate level of provisioning for the Bank.

15.92 **It is our view that the necessary level of general provisioning should be assessed in isolation from consideration of the arrangements, and that the degree of use of those arrangements should not be allowed to vary the original assessment of provisioning.**

15.93 We are somewhat concerned to see the Bank's directors acknowledging the possibility of adjusting the level of the Bank's provisioning to suit the circumstances.

15.94 **We further comment that the level of general provisioning should not be open to reductions in recognition of benefits apparently available under the** arrangements.

15.95 In addition, there appear to be factors, other than principle, which should have discouraged any compensating adjustments to general provisioning.

15.96 **A Bank paper over the name of Pyne, dated 20 August 1990, considered by the directors at their meeting on 27 August 1990 records:**

> ***By the time of the re/ease of the financial result for the year ending 31 March 1990, in June 1990, it was apparent that as a consequence of the position in Australia, the Bank may. potent.ally need to make further substantial provisioning in this year and in future years. In view of this, before re/easing the results, the Chairman and Managing Director approached the Minister of Finance*** **[then Hon D.F. Caygill]** ***to indicate that it was likely that the Bank would require an increase in capital and that work was underway to define the extent of the Bank's needs.***

15.97 In evidence Pyne said at p.1599:

> ***I am very clear what the chairman and I said to the Minister at the time in May was one of that we may need to address the Bank's profitability because of the non-recurn.ng Items in the profitability.***

15.98 Pyne was asked if those 'non-recurring' items the Minister was told about included the Bank's use of the arrangements. Pyne said no, and further informed us at p.1600:

> ***... What I was refem`ng to In non-recum.ng Items was the fact that we had ... sold Investments which were no longer going to generate Income for us.***

15.99 We consider that it was not reasonably open to the directors to lower the general provision for doubtful debts as an alternative to using the proceeds of the arrangements. In our view, subject to an analysis of the unders and overs schedule of the auditors which we consider in paras 15.122 et seq, the Bank's pre-tax profit for the year ended 31 March 1990 were overstated by $55 million.

15.100 We do not agree with the views of either Trow or Hays (arrived at in different ways) that th'e profit difference was immaterial in 1990.

15.101 We do not agree that the appropriate basis for measuring materiality is against an average of the Bank's recent profits i.e. the concept of .normal profit` referred to by Trow. in our view averaging has a limited degree of relevance to a cycle of financial results as follows:

1987	**271**
1988	255
1989	(939)
1990	45*

Commission's initial corrected figure

15.102 An averaging of results which has regard solely to profits, while deeming losses as abnormal or irrelevant, is suspect in our opinion.

15.103 We consider that the distortion to pre-tax profit arising from the Bank's reporting of the arrangements, measured against the Bank's corrected pre-tax profit for the year ended 31 March 1990, appears material.

15.104 We now proceed to examine the work of the auditors, E & Y.

D. *The Bank's auditors*

15.105 It was the view of E & Y that the influence of the arrangements on the Bank's reported profits, after taking account of their .unders and overs", had not been material in any of the years under review, including in 1990.

(a) The auditors' view of accounting for the arrangements_

15.106 E & Y said-matching- was an appropriate treatment for the arrangements in 1990. It should be noted, however, that this was a different concept of matching than that view described by us in this report. Hickey said that it would have been reasonable for the Bank to have adopted the .matching` principle from 1988 to 1991. She said in a written submission:

Matching

in March 1988 (and until comparatively recently - 1992 issue of ED6O Statement of Concepts), the matching of expenses and revenues was a primary accounting principle.

SSAP 1 para 4.2(b) -Matching of Expenses and Revenues._ Under accrual accounting, expenses and revenues are recognised as they are incurred or earned (rather than as money is paid or received) and recorded in the financial statements of the period to which they relate. Results for the pen_od are determined by matching expenses with the related revenues."

ED6O continues with the accrual basis of accounting, rather than

the cash basis. However, it indicates a shin In emphasis from -matching- as a primary accounting principle, to emphasis on recording assets and liabilities. ...

Value at Which Assets Recognlsed

The histon.cal cost system of accounting does not usually recognise the time value of money. That is a future receivable or payable is recagn/sod at the nominal amount to be received or paid without regard for the time pen'ad until expected receipt or payment. (Interest bearing receivables or payables are recognised at an amount that reflects time value of money, in respect of the total cash inflows or outflows, provided the Interest rate reflects approximate market rate.

15.107 **In** response to questioning Hickey said at p.611:

... ./ can accept that the alternative of an appropriate matching was perfectly acceptable at the time as well. In other words the treatment that / came up with In May 1990 .[the YTM method]... was my view of accounting for the transact/on in terms of its substance but there were arguments that could be made that an acceptable alternative was to account for it in terms of a matching concept. / believe that this alternative was an acceptable alternative in 1988, / believe It was st/// an acceptable alternative In 1990 but / believe the people looking at the transaction now In 1993 would not regard the matching as an acceptable alternative and the reason / say this is because of those two papers, the UKpaper and the US paper in September and December of 1991 which deal specifically with the transaction as opposed to the references ... made to FAS 5 and FAS 97...

15.108 E & Y included an assessed income overstatement of $27 million arising from the use of the arrangements in their 31 March 1990.Error Schedule" (see appendix M). This is described thus:

Insurance Po/lcy Overstatement - on a net present value method the Insurance benefits have been taken up in excess of the related costs.

15.109 E & Y explained that they derived this amount by applying the .matching. principle to the arrangements. Based on the Bank's originally intended 1990 claim of $100 million, that is half of the total sum insured, E & Y considered

that the Bank should expense half the premium i.e $55 million. Since the Bank was only charging $22 million in premium this meant there was an undercharge against income of $33 million. When the final claim was lowered to $94 million E & Y also took $6 million off the amount of premium undercharged in their unders and overs schedule, giving $27 million. They acknowledge they should only have deducted $3 million.

15.110 E & Y's computation takes no account of the fact that the Bank would not receive the proceeds of its claim for three years. Their reasoning is explained in a file note "Bank of New Zealand 31 March 1990 Year End Issues" dated 11 May 1990 and signed by Hickey. She said:

> *Because the bad debt provisions against which the Insurance claims are being netted will not accrue further Interest over the period until the claims are `paid, I have accepted an accounting treatment that does not Involve recognition of Interest on the deferred settlement of the Insurance claims. However, the accounting treatment currently adopted by the BNZ Is unacceptable on a matching basis. The insurance premiums should be matched against recognition of the claims, and not on a time basis.*

15.111 We do not agree with this line of reasoning for the following reasons:

(a) The arrangements were not in substance an insurance arrangement with the transfer of risk. The amount the Bank could claim was determined solely by the interest yield obtained on the investment of the premium payment. Settlement of claims was deferred solely in order to allow that interest income to accumulate;

(b) Non-recognition of the interest on the deferred settlement of the insurance claim is the equivalent of recognition of the compounding interest on the zero coupon bonds as income in advance of the periods in which that interest would be derived. Such anticipation of income is unacceptable;

(c) **As we have outlined earlier in our report, it did not recognise the substance of the arrangements.**

15.112 In our view E & Y's version of "matching- was flawed. The matching approach used by the Bank in earlier reporting periods had regard to both the &mortised premium cost and the interest accruing (foregone) on the deposionds. The later version used by E & Y does ggt take account of the interest "foregone" by the Bank.

15.113 **In our view** E & Y did not correctly apply the "matching" principle to the arrangements.

15.114 In our view the appropriate level of overstatement to have been recognised in the "Error Schedule" on account of the arrangements should have been the $55 million difference between the application of the YTM basis and the basis used by the Bank.

(b) Advice given to the directors of the Bank

15.115 The directors of the Bank received advice from E & Y that the Bank's proposed treatment of its intended use of the arrangements in 1990 may have been incorrect. The first record of this is in the minutes of the Audit Sub-committee meeting of the Bank on 11 May 1990 where it is stated:

> *In this years audit review Ernst and Young have utlllsed their senior technical partner, Liz Hickey, with a full review of all the Bank 's accounting policies and practices Including this [loss insurance} policy. Ms Hickey indicated that the accounting treatment which was agreed by the auditors in financial year ending 1988 may not now be in line with emerging and developing accounting practices.*
>
> ***In reviewing these comments the directors noted there is now variance on this matter and they consider it appropn`ate to maintain a consistent treatment for this policy.***
>
> ***Later Peter Gerty reconfirmed the accounting treatment included In the***

Oran Accounts

15.116 Apart from this **reference there** is no evidence that Garty `reconfirmed the **accounting treatment" for the arrangements. We know the auditors accepted the financial statements as a whole. We note from E & Y's records, in the file note referred to in para 15.110, that Hickey says:**

However, the accounting treatment currently adopted by the BNZ is unacceptable on a matching basis.

15.117 Garty, in a file note-Bank of New Zealand 31 March 1990 Year End Issues`, dated 11 May 1990, said:

I also informed the meeting [of the Bank's Audit Sub-committee} that we were looking at the treatment of the perpetual note and the insurance policy. A discussion ensued ..... I noted that there were some prob/ems with the insurance policy and matching the revenue with the related costs.

The Directors are Of the view that this insurance policy value, la $200m can be taken up at any stage as this is the nature of the product. However I stated that they may have to match the premiums against the value they take up. I do not believe that the Directors accept this position.

We will need to follow-up with Don She/ton and Char/es Purvis.

15.118 Garty's subsequent-Report to Management 1990`, provided to the Bank under cover of a letter of 17 July 1990 addressed to Pyne, said:

BNZ Group Accounting Issues

1. Insurance Premium

The insurance premium of $110 m is being taken to Profit and Loss account on a straight line basis over the five year "life" of the policy.

In our opinion, the treatment is not strictly correct and the premium should be matched against the revenue taken under the policy.

In 1999 there was no effect of adopting our recommendations because

under either method the amount taken to Income and expenditure was the same. However in 1990 a difference of $27m exists between the two methods.

Although we did not propose an adjustment for the above, because of /ts /mmater/a/ltY when considered with other possible adjustments of lesser amounts, we would recommend consideration be given to adopting the method we have suggested in the 1991 Financial Statements.

15.119 **It has been noted that Hickey had advised the Bank that the treatment agreed by the auditors in the 1988 financial year -may not now be in line with emerging and developing accounting practices'. The minutes in question do not state whether Hickey also added that the 1990 treatment had departed from that used in 1988.**

15.120 We conclude that the auditors did not approve the accounting treatment adopted by the Bank for the arrangements in the financial statements for the year ended 31 March 1990 and observe that this view was expressed by Garty to the members of the Bank's Audit Sub-committee at its meeting on 11 May 1990. It was confirmed in the Report to Management of 17 July 1990.

15.121 We will now examine the compilation of the auditors' `unders and overs` schedule.

(c) The auditors"unders and overs` schedule_

15.122 E & Y provided us with an original .Error Schedule. prepared by them in respect of their audit of the accounts to March 1990. This records the basis of their conclusion that the distortions to the Bank's profitability arising from various sources, including the arrangements, were not material. That schedule concludes that there was a profit overstatement of $7.3 million for the March 1990 year. A copy of the schedule is included in the report as Appendix M.

15.123 E & Y's "Audit Planning Memorandum" for the year ending March 1990, when discussing "Planning Materiality", includes:

> **We *believe that the operating results and shareholders equity will be the key figures on which external users of the financial statements will focus, and we will therefore use these figures as the base for our ca/cu/at/ons of PM* [planning materiality].**

15.124 The document then reviews a number of measures, based on averages of the outcomes over the preceding four years, but also including the budgeted profitability for the year, before concluding:

> ***The most appropriate figure for PM therefore appears to be -$BM based on operating results before provisions and tax, budget 1990 profit after tax, and shareholders equity.***
>
> ***This gives* a *tolerable error of $4M.***

15.125 On the face of it a net overstatement of profit of $7.3 million, on a reported profit before tax and extraordinaries of $100 million, is in the marginal area but may not be considered material. We note that it is at the limit of the level of E & Y's`planning materiality."

15.128 We have carefully reviewed E & Y's approach to the calculation of audit differences. There are a number of areas where we disagree with their assessments. Later in this section we present our own revised schedule. The purpose of this is not to restate 'overs and unders" with the benefit of hindsight, but to exclude errors which should have been clear at the time.

15.127 We accept without comment the three items, "Sale of London Building- "Overaccruals" and "Gratuities Overstated".

15.128 We have already reviewed E & Y's treatment of the arrangements. As we noted, in our view E & Y should have included a variance of $55 million arising from the misstatement of income from the arrangements, not the $27 million which they did.

15.129 The Error Schedule also includes a netcf-tax amount of $13 million ($20 million before tax), shown as an understatement of profit, and explained as:

> ***Restructuring costs taken up In the accounts which we do not consider to be required as they are an ongoing expense.***

15.130 We note that the Bank treated its restructuring provision as an extraordinary item. Accordingly in our view this understatement is not relevant when computing the impact of the various accounting differences on the Bank's profits before tax and before extraordinaries. It should not have been brought into the schedule. In our revised schedule we have omitted this item from the assessment of the overstatement of pre-tax profitability.

15.131 Trow has given evidence that many commentators would have returned the restructuring provision to an-above-the-line' item when analysing the Bank's financial statements, and he considers the Commission should do likewise.

15.132 Whatever commentators may have done, the Bank included the restructuring provision below the line and the auditors did not qualify the accounts as a result of that treatment. We have to deal with the financial statements as they were **presented by the Bank and using the contemporary materiality measures.**

15.133 We include a further item in our schedule relating to an income overstatement on account of the Bank's treatment of its issue of Perpetual Subordinated Capital Notes (.the capital notes") which were made in 1988. We were alerted to this item both through Sadler's note to the Board identifying that $32 million was included in the Bank's 1990 profits on account of the amortisation of these notes and because E & Y included variances in subsequent `summaries of audit differences" schedules for 1991 and 1992.

15.134 By way of explanation the Bank raised US$200 million by the issue, through a subsidiary, of the capital notes. The interest rate the Bank paid was related to market benchmark rates. The Bank immediately purchased, for around US$54

million, a zero coupon bond with a maturity value of US$200 million in 15 years time. The investors in the capital notes have control of the zero coupon bond` and we understand will be repaid from its proceeds in the year 2003.

15.135 The capital notes have been recorded in the Bank's balance sheet at their net value i.e. the original issue price less the current assessed value of the zero coupon bond. As the value of the zero bond goes up the Bank's net exposure to the capital notes goes down.

15.136 The Bank's 1989 financial statements did not include any adjustment on account of the increasing value of the zero coupon bond. It was explained to us that this was an oversight because there were so many other issues being dealt with in the accounting area at the time. In 1990, however, the Bank 'caught up` and included adjustments for both. 1989 and 1990. The gross amount taken was $32 million, of which $16 million related to 1988/89.

15.137 We agree that the increased value of the zero coupon should be recognised in the Bank's income. Arguably the inclusion of the 1988/89 adjustment in March 1990 income should have been separately disclosed, given its size. Our concern, however, relates to the Bank's method of calculation, which was to **record the accretion in value of the zero coupon bond on a straight-line basis. Thus the growth of the bond over 15 years, around US$145 million, was being brought into income at the rate of US$10 million per year.**

15.138 In our view the accretion to income should have been computed on a YTM basis especially as the bond was of a type computed with a fixed yield over s fixed period of time.

15.139 Coopers, in their.Operational Review Report in March 1991, advi.sad that YTM was the correct accounting treatment. They computed the variances arising from the difference between a straight-line and a YTM basis. For the years 1989 and 1990 these income differences amounted to US$6.2 million and

US$5.8 million respectively. This meant that the Bank had overstated its income in 1990 by (US$12.0 million @ 0.58) $20.7 million.

15.140 **We have subsequently received a submission from RWS that Coopers' computations were not correct and that on an alternative calculation basis, a basis which we are told was used by the Bank in November 1992 to restate the value of the Notes in the bank's financial statements, the overstatements are less. Coopers are said to have agreed that their earlier calculations were incorrect. We have decided to accept the revised basis put forward by RWS for the purpose of restating the Error Schedule. On the revised basis the income overstatement for 1990 is US$9.23 million @ 0.58, $15.9 million.**

15.141 **E & Y looked at this issue in 1990. In Hickey's file note of 11 May 1990 she describes the capital notes but does not indicate an awareness of the zero coupon bond. She acknowledges that the Bank is using a straight-line basis rather than a yield to maturity basis but concludes:**

> ***Because the Interest rate is a floating one based on LISOR, it is not possible to calculate the reduction in the perpetual capital notes on a yield to matun'ty basis. Accordingly, the Bank's adopted straight-line basis is accepted.***

15.142 In fact the amount of the income overstatement relates to both the interest rate on the capital notes, which was floating, and the yield on the zero bond, which was fixed.

15.143 it is worth noting that in November 1992, following the takeover of the BNZ by the National Australia Bank, the Bank changed its accounting policy with respect to the capital notes so that they were recorded on a YTM basis. The immediate impact of this change of accounting policy was reflected in an increase in the carrying amount of the Capital Notes from $198 million 81 31 March 1992 to $227 million at 9 November 1992.

15.144 Garty's .Error schedule_ also refers to the level Of specific and general_ provisions made in New Zealand and Australia. He states that, following his visit to Australia:

> *..., on the basis Of our review of the Australian loans we believe that there were some conservative provisions made in Australia and additionally there was general provisions made in excess of what we had expected. Il Is difficult to quantify this amount, however, it may be in the region of $20-30 million.*

15.145 We have the report Garty made to the Bank following his visit to Australia. In a loner dated 6 June 1990 to Pyne, Garty identifies one or two accounts where additional provisioning is needed and one which is over-provisioned by about $3-5 million. He does not record a view that Australian provisioning is $20-30 million too high. We found no evidence to justify this. Indeed the Bank's directors and management had serious concerns at that time about the Australian position.

(d) The Commission's Revised Unders and Overs schedule_

15.146 Based on the preceding analysis we have computed the following revised schedule Of audit differences:

Overstatement on account of the benefits taken under the arrangements	$55.0 million
Overstatement on account of the incorrect treatment of the capital notes	$15.9 million
Understatement on account sale of London building	($0.7 million)
Overaccruals	($1.0 million)
Gratuities Overstated	($5.0 milliOn}
Revised overstatement of 1990 profit before tax and extraordinaries	$64.2 million

15.147 We observe that, after revision of the "Error Schedule", the variance between the Bank's recorded pre-tax profit for the year ended 31 March 1990 and what we consider is the correct figure is now larger than the variance arising from the treatment of the arrangements alone.

15.148 We have already concluded that, in our view, a variance of $55 million in respected of a corrected profit figure of $45 million was material. Our view is even stronger when considering a profit overstatement of $64 million on s corrected profit of $36 million, an overstatement of 177.80/o.

E. *Our findings on the March 1990 financial statements*

15.149 The Bank's reported profit before tax and extraordinaries for the year ended 31 March 1990 was $100 million. On our assessment, based on our revised "error schedule", this was an overstatement of $64 million.

15.150 We believe the reporting of the pre-tax profit in 1990 of $100 million when it was $36 is indeed material. We have no doubt that users of the financial statements would have been misled to the degree that judgements and decisions made would be affected.

15.151 We view the 1990 overstatement of profits as material, a material distortion of the Bank's results for the year which was "fundamental' as the term is used in Auditing Standard No 10, -Audit Reporting", of the NZSA.

15.152 We conclude that the financial statements of the BNZ for the year ended 31 March 1990 did not present a true and fair view of the results for that period.

15.153 The overstatement of the Bank's shareholders' funds, at $55 million or 5.3% of the corrected shareholders' funds amount, was not material.

F. Our findings In relation to the performance of Ems! and Young

15.154 E & Y gave an unqualified audit opinion with respect to a set of financial statements for the BNZ for the year ended 31 March 1990 which did not, in our opinion, present a true and fair view of the results of the Bank for that period.

15.155 Gerty, in our opinion, derived false comfort from his error schedule. The incorrect treatment of the arrangements, viewed either in isolation or in conjunction with other variances, was material to the extent that the 1990 annual financial statements failed to show a true and fair view.

15.156 With respect to the Bank's treatment of the arrangements we consider that E & Y should have insisted that the Bank adopt a matching approach which equated the benefits taken by the Bank with the full cost of the arrangements (the amortised premium plus foregone interest) to account for its use of the arrangements in 1990 rather than the version of `matching_ which E & Y advocated.

15.157 In our view E & Y should not have incorporated, in their 'error schedule', an amount of $27 million as the variance arising from the Bank's use of the arrangements. The amount should have been $55 million.

15.158 In our view E & Y should have included an income overstatement of at least **$15.9 million on account of the Bank's incorrect treatment of the capital notes. The omission of such an adjustment was an unfortunate error.**

G. *The position of the directors of the Bank*

15.159 The Bank's, directors approved the publication of financial statements for the Bank for the year ended 31 March 1990 which did not, in our view, present a true and fair view of the results of the Bank for that period. Were the

decisions they made, which resulted in the publication of the financial statements in the form they took, reasonable having regard to the advice they had received or had available to them?

15.160 We now examine these questions.

(a) <u>Directors' beliefs as to the nature of the arranqements_</u>

15.161 Several directors gave evidence as to their understanding of the arrangements

15.162 **Congreve said at p.1341:**

> ***I considered it to be a genuine captive insurance arrangement that offered certain flexibility to the Bank In terms of the provisioning over the period of the arrangement.***

and at p.1358:

> *Well,* all */ can say to the Commission Is to repeat that I viewed this as being a valid insurance policy which enabled the Bank to make a claim In the year 1990...*

15.163 **Pyne told us at p.1497:**

> ***I considered It to be a genuine insurance. It was something that had been looked at very closely by the Bank's auditors. It had been looked at by the Bank's legal firm. Certainly we had the benefit of both Dr Lo/kine' and Mr Sad/or who I have the very highest respect for in terms of their professional qualifications indicating that that was what it was for. It was established for provisioning. I never really questioned it.***

['Lojkine has reviewed this statement by Pyne. She observes that she was no longer a director in 1990 and that at no time had she argued that the arrangements constituted genuine insurance}

15.164 Sadler said at p.209, on the nature of the arrangements

> ***No not an insurance policy with a transfer [of! risk definitely not.***

15.165 8adler is also recorded as having said, in the minutes of a meeting of the Operational Review Committee held on 13 March 1991, referring to the arrangements:

> ***David Sad/er commented that /t had been adopted prior to his appointment to the Board but he had always seen /t as an income smoothing device.***

When asked by us whether this was still his view 8adler said at p.209:

> *Yes but /t wouldn't have had to be used.*

(b) <u>Advice received by the directors concerning the accounting treatment for the</u> arrangements

15.166 We have already observed that the directors on the audit sub-committee of the Bank received advice from E & Y that there should be a "matching" of the costs charged against income with the benefits taken.

15.167 Pyne also received advice from the Bank's Chief Financial Officer, 8helton.

15.168 **In evidence before the Commission 8helton referred to -budget meetings' with Pyne and divisional managers. He was asked whether he said anything at those meetings about the use of the arrangements that was proposed. He said at p.140, 2nd hearings,:**

> *At that time / said to him [Pyne] that / wasn't comfortable with the insurance arrangements nor was / comfortable with the perpetual notes.*

RMcV submitted to us that these comments would have been made in the context of wide ranging discussions where many views may have been expressed.

(c) Knowledge of the previous Board's accounting policy

15.169 We have concluded that the 1990 Board departed from the accounting policy for treatment of the arrangements applied by the Bank since October 1988. Several directors commented on this issue.

15.170 On the Board's knowledge of, and reasons for departing from, the previous use of the arrangements, Sadist told us at p.231:

No I wouldn't have been aware of it [the Board's previous policy} at that time [May 19901.

and at p.215:

There were no motivations [for the /eve/ of use in 19901. The Insurance policy was there for a rainy day as I've heard it descnbed and It was used for that rainy day because in March 90 that was seen as the peak of bad debt provisioning.

15.171 On his knowledge of the Board's previous policy on usage of the arrangements Congreve said at p.1345:

No I wasn't aware of any such policy at any time.

15.172 On the manor of the his knowledge of the Bank's previous use of the arrangements and of the Board discussions in October 1988 Pyne told us at p.1495:

No I don't think so. As again I didn't look back in the past. You know to me It was a product I didn't really understand at the time. We didn't need it [In 19891 because of the genera/ provisioning and really had relied, I probably relied a lot at the half-year [September 19891 on those who had been on the Board pn.or to that,...

15.173 **Fay was asked if he was aware of the basis of usage of the policy in the year's prior to 1990. He told us at p.1714:**

> ***Probably only In the context of the numbers that were be/ng looked at as to how much we could cla/m. I probably would have become aware that there had been a cla/m in the previous year of $40 ml/lion I think, which gave us the $160 ml///on balance In the pol/cy...***

and, on the 1988 Board's rationale of offsetting costs and benefits, he said at p.1714:

> ***No, there wouldn't be a lot of po/nt In hav/ng It If that was go/ng to be your treatment of It.***

(d) Reliance on the auditors' unders and overs

15.174 It is relevant to note the extent the directors may have relied on the auditors overall assessment of the Bank's financial statements.

15.175 Sadler said at p.241:

> ***We/l I don't rely on the prov/sioning argument, I could fa// back and I don't th/nk I need to. I could fa// back on what was the overall impact on earn/ngs for the year when you take account of the auditors' anders and overs. Nothing.***

15.176 **Pyne said at p.1552:**

> ***If you looked at the bottom /Ina the item was not material once you took Into account the anders and overs that the auditors had gone through.***

15.177 **Fay said at p.1739:**

> ***...I do recall that there was some discussion as to materiality wh/ch I suppose would impact on your v/aw of d/sclosure to the extent it was mater/al, ... and I th/nk we d/d have a netting OH, a sort of an anders and overs arrangement which did Include the net pretax effect of using $54 of the prows/on to Insurance pol/cy age/nst It. ....***

Ce) **Submissions on behalf of the directors_**

15.178 RMcV have submitted on behalf of certain former directors of the Bank:

In this case, the Commission had direct evidence from some of the directors as to their actual beliefs about the nature of the transaction. Quite simply, the directors believed that it was an insurance policy because all the information available to them indicated It was and In fact It was an insurance policy. Only in 1991 were concerns as to accounting treatment raised by accountants. These concerns were never subjected to a thorough legal analysis and arose principally from changes in accounting trends.

15.179 With respect to Sadler's comment that he did not consider the arrangements an insurance contract RMcV submitted:

...that statement was made with hindsight, having seen the Commission's 1992 Summary of Materials, and, more importantly, was the view of an accountant on an issue of law.

15.180 **On the question of the reasonableness of the directors' belief that the arrangements were genuine insurance RMcV submitted:**

The reasonableness of these beliefs is to be judged partly subjectively and partly objectively. The subjective element relates to the experience and expert/`se Of the part/.cu/ar directors involved. The objective element relates to the surrounding circumstances and knowledge available to the directors ***at the time.*** *There is a very great danger of imputing to the directors knowledge gained with hindsight, the appropriateness of subsequently developed views, and the know/edge or views of others, either at the time or subsequently. There is a part/.cular risk in these circumstances, where the Commission has over many months, and years later, heard from many people and contemplated at its leisure arrangements which were already in place and which were presented to directors In the middle of a part/'cular!y heavy "rainstorm-.*

The following are relevant circumstances in assessing the reasonableness of the directors' belief:

(a) ***.The transaction was already in place. The new Board was not considen.ng its appropriateness but was entitled to assume, In the absence of any indication to the contrary, that the contract was a valid one.***

*(b) **The form of the transaction was a contract of insurance format.***

(c) ***It was presented to them as an insurance arrangement. It was always described and referred to as an insurance arrangement. The directors were entitled to assume, in the absence of any indication to the contrary, that was so. Indeed, at paragraph ..... of the draft Report, the Commission finds that the previous Board was entitled to rely on advice to it by staff.***

(d) The arrangement had been used as insurance in the past.

(e) ***There had been no suggestion from the carry-over Board members that It was other than an presented by the staff, an insurance arrangement. Mr Bayliss believed right up to the time of the enqully that it was an Insurance arrangement.***

(f) ***It had been accepted in the past by the auditors as insurance.***

(g) ***The directors did not look at the documents themselves - there was no reason given the foregoing for them to do so. It would be extraordinary to suggest that directors inheriting all the transactions that a Bank of that size had entered, that the new Board should have reassessed a particular transaction when there was no apparent reason why they should. However, even on doing so, the form of the documents Indicated an insurance arrangement to these particular directors with their individual levels of experience and expertise. They would have found approval (apparently at least) by lawyers and auditors. To suggest that they should have formed & contrary view of something as complex as this transaction In those circumstances would be unreal.***

(h) ***Even today there has been considerable debate as to the true nature of the arrangement. Differing views have emerged. In 1991 the issue was raised by Ernst & Young and Coopers & Lybrand. They are accountants and not lawyers and were dealing with a legal issue. It is apparent that there is a very substantial market for such arrangements and they do not fall neatly into two classes - "pure" insurance and pure financial arrangements. There Is instead a continuum, with a very great range of permutations. There is no clean cut OH but a large middle are& where distinguishing between the two categories is -difficult- indeed. Even arguendo, the arrangements were not a contract of insurance, the directors could not be expected, in 1990, to be able to determine that issue. However, in fact and law, it was insurance and they were duty bound to treat it as such.***

(0 ***The Commission has already found that the prior Board (which implemented the arrangement and accordingly had good reason to***

> ***examine it in detail), were reasonably able to consider that it was insurance... It would be extraordinary to suggest that the later Board, which had no reason to reassess It, should have considered it as anything else.***

In the light of the situation the new Board found itself in, it is clear that In March 1990 there was nothing which would, or should, have led It to reconsider the nature of the transaction which was presented to it as an insurance policy. It was there, it had been used, It was available for use, and the then current circumstances suggested It was appropriate to use It again. Even if the new Board had In fact looked back and reconsidered the arrangement, there was nothing in the history available to the directors, either in the documents themselves, the formation history, the prior treatment or the advice from lawyers, which would lead them, as insurance "laymen" or reasonable businessmen, to consider it as anything other than had been presented to them. The Commission's [draft] finding on the appropriateness of the previous Board's view makes that conclusion inevitable. The directors' clear belief that this was insurance was In the circumstances a reasonable belief. Indeed it was the only responsible belief.

(f) Our view of the directors' comments_

15.181 We have considered these arguments and submissions carefully.

15.182 In our view the directors on the Audit Sub-committee in 1990 understood the **substance of the arrangements. Whether or not they considered the arrangements to be genuine insurance, they knew that the Bank's accounting income was being materially boosted by inclusion of the proceeds of a large -claim" made under the arrangements. They also knew that the Bank would not receive the proceeds of the "claim" until 1993.**

15.183 Shelton told Pyne that the proposed accounting treatment of the arrangements did not have his support. The views of the Bank's Chief Financial Officer seem to have been ignored. We think they should have been given greater weight.

15.184 The accounting treatment adopted by the directors in IggO was not in accordance with the advice of the Bank's auditors, E & Y. The Bank's directors` chose not to follow the "matching" policy advocated by E & Y. While E & Y were prepared to give an unqualified audit opinion of the financial statements this was only after taking account of their "unders and overs.. It does not appear that these were fully discussed with directors. We do not think the directors of the Bank should have relied on their knowledge that the auditors were prepared to give an unqualified opinion in the circumstances without carefully scrutinising the auditor's reasons.

15.185 Not all members of the Board in IggO could have been exposed to the same level of knowledge of the background of the arrangements, the earlier accounting treatment, or the views of the Chief Financial Crfficer. Nevertheless, those directors to whom the rest of the Board looked for guidance and advice, the members of the Audit Sub-committee, were better equipped to guide the Bank to the appropriate accounting policy. it appears that they did not.

15.188 In 1888 and 1888 the directors considered it inappropriate to make a claim under the arrangements for an amount which exceeded the accumulated costs to that point of foregone interest and &mortised premium, thereby anticipating income. In our view the IggO Board could reasonably have been expected to come to the same conclusion.

16.0 FINANCIAL YEAR ENDED 31 MARCH 1991

Interim financial etatemente for the half-year ended 30 September 1990

The fl_`.'nancial_,statements

16.1 From September 1990 the Bank, while continuing to claim the remaining benefits under the arrangements, no longer offset these against the charges for doubtful debt provisioning in its audited annual accounts. Instead the amounts claimed were used to enhance the level of the Bank's interest income.
However it is apparent from the Bank's working papers that adjustments were still made to the level of provisioning in the unaudited half-year financial **statements.**

16.2 In the Bank's budget for 1990/91, approved in May 1990, it was intended to claim $60 mHlion of benefits under the arrangements for the full year to 31 March 1991. Accordingly, for the half-year to 30 September 1990 we assume that the Bank took in benefits half the intended amount, or $30 mHlion, of which **$10 mHlion was offset against the level of provisioning. The effects on the Bank's published financial statements included:**

Profit and Loss A/c half-year ended 30/9/1990

	Bank	YTM	**Variance**	
Provisions for doubtful debts (net)	$10 mn	$20 mn	-$lOm	-60.0o!o
Operating profit before tax and extraordinaries	$86 mn	$76 mn	+$lOm	+132o/o

Balance Sheet as at 30/9/1990			
	Bank	YTM	Variance
Shareholders funds			+$62m+8.2o/o

Note: adjustments to balance sheet levels of provisioning no longer calculated since the amount of $94 million, previously offset against the arrangements up to 31/3/1990, was added back to the provisions in these financial statements.

16.3 **The results for the half-year to September 1990 reflected the continuing effect of the decisions made by the Bank in March 1990. The amount of benefits claimed was $10 million in excess of the cost, as measured by the premium amortised and the interest income foregone, of the arrangements.**

The appropriateness of the Bank's accounting treatment for the arrangements

16.4 **The benefit amount claimed in the half-year exceeded the cost of the arrangements for the same period. Accordingly the accounting treatment did not comply with the Bank's general accounting policy.**

16.5 For the reasons already outlined in the preceding section the Bank's accounting treatment did not accord with the substance of the arrangements and did not have authoritative support.

16.6 The accounting treatment adopted was probably consistent with that followed in the full year to 31 March 1990 in that the benefits claimed exceeded the cost of the arrangements and this excess was probably used to reduce the charge for doubtful provisioning. Consistency is, of course, no justification for continuing with an inappropriate accounting policy.

16.7 **We conclude that the accounting treatment for the arrangements used by the Bank in the interim accounts for the half-year ended 30 September 1990 was not appropriate.**

16.8 As noted in the table this resulted in an overstatement of $10 million in **the Bank's operating profit before tax.**

Our view on the September 1990 financial statements

16.9 **Although at first sight these enhancements to profit before tax and shareholders funds could be considered to be material, the financial statements were published in a half-yearly report which described the Bank's already announced "Adbro" restructuring.**

16.10 **That restructuring included increased equity capital, notice of additional doubtful debt provisioning of $797 million which was recognised after balance date, and the establishment of an associated company, Adbro Investments Limited owned jointly by the Crown and Fay, Richwhite & Company Limited, to which a large volume of the Bank's doubtful loan exposures was to be transferred. Further details of the restructuring are explained in the Bank's press release of 5 November 1990 which is included as Appendix N.**

16.11 **These interim financial statements also included a large prior period adjustment which removed $315 million from the Bank's retained earnings on account of**

16.12 **In the circumstances we do not consider the variances resulting from the arrangements were sufficiently material to affect the truth and fairness of the Bank's financial statements for the half-year to 30 September 1990.**

Audlted flnanclal etaternente for the year ended 31 March 1991

A. *The financial statements*

16.13 The financial statements for the year ended 31 March 1991 included the transactions related to the establishment of Adbro Investments Limited, the transfer to that company of a large quantity of the Bank's bad and doubtful debts, and the recapitalisation of the Bank.

16.14 **The Bank included in its income $38 million of benefits under the** arrangements, $22 million less than the $60 million originally budgeted. This amount was effectively credited to operating profit with none being offset against the provisions for doubtful debts.

16.18 The effect on the Bank's published financial statements was as follows:

Profit and Loss A/c year ended 31/3/1991

	Bank YTM		Variance	
Operating profit before tax and extraordinaries	$176 mn	$178 mn	-$2mn	-1.1%
Operating loss after extraordinaries	($71 mn)	($69 mn)	**-$2mn**	-2.9%

Balance Sheet as at 3113/1991

Shareholders funds	$912 mn	$888 mn	-$86 m	+6.So!o

16.16 Although the effect of the Bank's use of the arrangements on profitability was negligible, there was still an influence carried through to the closing level of shareholders' funds.

S. *The appropriateness of the Sank's accounting treatment for the arrangements*

16.17 **The amount of benefits taken by the Bank, $38 million, almost equated with the "costs" of the arrangement for the same period, $40 million. Accordingly the Bank's general accounting policy was complied with.**

16.18 **For the reasons already outlined, however, the accounting method for the arrangements did not accord with their substance and did not have authoritative support.**

16.19 **The Bank also changed its method of recording the benefits under the arrangements. These were now all added to operating income rather than some portion being offset against the doubtful debt provision.**

16.20 **We conclude that the accounting treatment used for the arrangements by the Bank in the financial statements for the year ended 31 March 1991 was not appropriate.**

16.21 **The impact on the Bank's pro-tax profit of the continued use of this inappropriate accounting treatment, at only $2 million, was not material. There was an overstatement of the level of the Bank's shareholders' funds by $56** million. This also was not material in the context of the Bank's financial **statements as at 31 March 1991.**

C. *Our views on the March 1991 financial statements*

16.22 **In our view the level of the Bank's shareholders' funds was overstated at 31 March 1991 by an amount which, while significant in absolute terms,` was not material in terms of the applicable accounting standards. The Bank's results for the year ended 31 March 1991 were not affected by the use and accounting for the arrangements during the year.**

D. Implementing a change In accounting policy

16.23 Ordinarily we would not comment further on financial statements where the impact of use of the incorrect accounting treatment for the arrangements did not appear material. However the directors of the Bank received advice from E & Y and Coopers prior to the finalisation of the financial statements which required them to address the question of the continued method of accounting for the arrangements. We will review that advice, and the directors' response to it. In addition there are aspects of the auditors' computation of their overs and unders which we wish to consider at greater length.

a) Advice from Ernst and Young

16.24 The Bank received advice during the 1991 audit that E & Y no longer considered the arrangements should be treated as an insurance arrangement but as a financial arrangement. In the 1991 Report to Management of the Bank E & Y said:

> ***As previously advised, we believe the receipts under the policy should be accounted for on a yield to maturity method, as although the transaction is an insurance arrangement, in essence we consider it more comparable to a five year coupon investment. ...***

16.25 The directors did not follow this advice

b) Advice from Coopers and Lybrand

16.26 In 1990/91 the Bank commissioned Coopers to undertake part of a wider Operational Review. The Review was undertaken by the Bank at the request of the Minister of Finance (Hon Ruth Richardson) and covered major areas of the Bank's operations. We have already referred to the report in previous sections.

`16.27 **At page 64 of the Coopers' report to the Bank, under "Bad Debt Insurance' the report states:**

Accounting Treatment

5.6 FASB 5 paragraphs 44 and 45, and FASB 97 paragraph 15, state that where there is no transfer of risk and part or all of the premium paid is in the nature of a deposit, then the arrangement should be accounted for as an investment in accordance with the substance. BNZ has accounted for this transaction as an insurance policy by:

a)expensing the insurance premium over five years,'

b)accruing a claim recovery on bad debts,' and

c)accruing notional income foregone."

[The report then includes a comparison, not reproduced here, of the effect of the two methodologies, based on a $66 million'claim- for 1991.]

5.6 This comparison highlights a large difference in timing of reported earnings. Whilst the total income over the five years is fixed at $90m..

a) ***the BNZ's current treatment results in significant additional income in the initial three years, offset by losses thereafter; whereas***

b) ***the alternative treatment spreads the $90m reasonably smoothly over the five years.***

5.9 If the accounting policy was to be changed at 31 March 1991 (and enacted as a pn.or period adjustment) the enact would be.'

a)a reduction of $57m in opening shareholders' funds,'

b)a reduction of $26m in current year's profits,' and

c) *an improvement to profits of approximately $41m and $42m in each of 1992 and 1993 respectively.*

5.10 Whilst the alternative treatment outlined above is more supportable, a change in accounting policy at this stage (enacted as a prior period adjustment) may raise public concern as to the motives behind such a change. This factor should be considered in determining whether a change

16.29 **We questioned the Coopers partner responsible for the work on the arrangements, Chin, about the form of their recommendation in their paragraph 5.10.**

16.29 Chin explained that Coopers were not carrying out an audit role but were rather giving advice on ways the Bank could improve its operations and its credibility. He said at p.566:

> ***When you make a prior period adjustment you start shifting items, which should have gone through profit and loss, directly against retained earnings and therefore these items don't go through profit and loss. ... /f we had done a prior period adjustment we would have significantly enhanced the earnings in the subsequent two years. Now, whilst the informed reader will understand what's going on, occasionally you could get readers who would suggest that the Bank was up to something unusual, to perhaps enhance its earnings in later years. ...What we are saying here is that, whilst we have identified an alternative treatment, In implementing an alternative treatment they may have done more damage to their credibility, which was the whole objective of this operational review, than would have been the benefit. Now that comment is made, of course, without regard to the materiality of this adjustment to the financial statements.***

and at p.573;

> ***Right now the issue of credibility really applies only where the items are not material and then you ask yourself we// do we need to make this adjustment. /f it's not maten`a/ and if it's going to damage our credibility /et's not make it. That sort of option really only exists when the amount is not material.***

(c) The Bank's res onse to thevice from Coo ers & L brand

16.30 Minutes of the meeting of the Operational Review Committee held on 12 April 1991, chaired by Fay and attended by Sadler, Pyne, James Ogden (CS First Boston) Sam Knowles (BNZ) and Stephen Norrie (Fay, Richwhite) (and apparently with attendance by other BNZ personnel as required) have been referred to earlier in our report. They include:

> ***He [She/ton] commented that Coopers & Lybrand were prepared to /eave the treatment as it was as they considered that a change at this time would not provide a -true and fair view-. On the other hand, Ernst Young were not now happy with the current treatment and wished to change It at this year end.***
>
> ***Michael Fay queried what the auditors attitude had been In previous years.***
>
> ***David Sad/er commented that probably the best alternative was to continue with the status quo and note the correct treatment In the accounts.***

16.31 **We note that the Coopers' view recorded in these minutes does not accord with their written report and not with their evidence to us. Shelton, in evidence, said that the expression "true and fair" may have been used in a "loose" way.**

16.32 **Fay, who was the chairman of the Operational Review Committee, said in evidence at p.1762:**

> ***I think the committee ... and subsequently the Board were Of a view that you wouldn't change it, and quite frankly, as I recall, Irrespective Of the written minutes ...I think on balance as I recall It Coopers and Lybrand would not have changed It either.***

and at p.1763:

> ***...maybe It should have been viewed differently In terms of was It a real insurance policy, we// the answer is it was treated as an Insurance policy...***

16.33 **Shelton was asked to comment on why the Bank continued to treat the arrangements as an insurance contract despite the Coopers' advice and his own view that the arrangements were not an insurance contract. He said at p.844:**

> ***It was a continuation of the previous policy and It wasn't a situation where my persona/ opinion was necessarily relevant.***

(d) Evidence from expert witnesses_

16.34 Trow said he thought the Bank should not have changed its accounting policy in 1991. He said at p.315 that such a change:

.would create more prob/ems than It would solve

16.35 **Hays' view is that 1991 is the earliest date at which the directors of the Bank might reasonably have made a change in accounting policy. However he also said:**

4.4 ***..If was also just as reasonable for them to make the decision to cont/nus the same accounting policy on a basis consistent with previous years, particularly In the knowledge that the arrangement was not long term and would come to an end after a further 2 years.***

4.5 ***I would also note that to date there have been no statutory or other rsgu/atoly requirements enacted, nor Statements of Standard Accounting Practice issued, that would have required the BNZ to change /ts practice from treating the arrangement as an insurance policy.***

16.36 Gerty also commented at p 496

I think It's more //ks what Coopers said In that last paragraph they were so far down the track with It to change at that stags would have been more undesirable.

and, also at p.496

We// I think It may have been seen to be or certainly would have been seen them back down from their previous ut///sat/on of the policy and secondly *If It* **got out** *It* ***may have raised some public concern that that change could***

occur particularly if they put it as a prior period they would have to explain what it was and that they may have raised more issues than It would have solved.

(e) Our comment_

16.37 **The Board elected not to incorporate the changes which would have ensured "best international practice' with a preference for-credibility- that remained the approach throughout the remaining years of the arrangement.**

16.36 **Had the Bank changed its accounting policy in 1991 there would have been a prior period adjustment in the Bank's financial statements, decreasing the opening level of shareholders' funds and increasing profit for 1992 and 1993.**

16.39 Such a change may have lead to criticism of the Bank because it would have exposed the Bank's use of the arrangements in the past and the impact on its future profitability.

16.40 In our view the need for financial statements to provide a true and fair view should override any issue of the credibility of the issuer of those statements.

16.41 **Because a change of accounting policy would have corrected the overstatement in shareholders' funds and removed a foreseeable, potentially material, distorting effect on the Bank's future profitability, in our view the Bank should have changed its accounting policy for the treatment of the arrangements in 1991. This would have necessitated a consequential prior period adjustment in its 1991 published financial statements.**

16.42 In our view Coopers in their report should have added the additional qualification, as communicated to us, that their advice would not apply if the amounts were considered material. On the evidence of the minutes, and of **Fay, the Bank appears to have construed Coopers' advice as being that a**

change in accounting policy would result in financial statements that did not present a true and fair view. Although this may have been the way Coopers' advice was communicated to the Committee by Shelton, it was not the formal advice given by Coopers. Indeed if it were we do not consider it would have been sound advice.

E. E & Y's overs *and anders <u>calculations</u>*

16.43 **E & Y's `Summary of Audit Differences` as at 31 March 1991 (included in the report as Appendix 0) concluded that profit before tax and extraordinaries of $176 million was overstated by $16 million, and the loss after tax and extraordinaries of $71 million was understated by $1 million .**

16.44 In the schedule E & Y included $54 million profit overstatement on account of the arrangements. They also include an offsetting amount of $30 million profit understatement from their assessment of an accumulated yield to maturity **difference on the capital notes.**

16.45 **,In terms of the Bank's 1991 profits the annual impact of the Bank's treatment of the arrangements was only $2 million, not $54 million. In our view $2 million is the amount which should have been included in the Schedule.**

16.46 E & Y, not having previously made any adjustment on account of earlier miscalculations in respect of the capital notes, included an amount in their 1991 schedule for the 1969 and 1990 as well as 1991 financial years.

16.47 **We have been provided with details of E & Y's calculations. E & Y appear to have measured the accruing interest on the zero coupon bond on the basis that the annual amount of interest is reducing over the relevant period in contrast to the reality of the matter which is that interest is to be calculated on an increasing compound basis.**

16.48 **The** difference we calculate to include in the unders and overs schedule Is a profit overstatement of US$3.89 million @ 0.59, $6.6 million. This contrasts with the profit understatement of $30 million included in E & Y's schedule.

16.49 Our revised "Summary of Audit Differences", taking all other items as correct, would show an influence on pre-tax profits of:

Other differences, net	-$8 million
Arrangements	-$2 mHlion
YTM on capital notes	+$7 million
Net Impact on profit before tax	**-$3 million**

16.50 E & Y's schedule includes an "extraordinary" item for a capital profit of $17 million on the sale of the Bank's Western Samoan operation which was apparently not included in the Bank's accounts at 31 March 1991. We assume this would only be a timing difference. We note that in 1992 the Bank recorded a profit of $1 million on sale of non-core operations.

Our comment on the performance of Ernst and Younq

16.51 **In our view E** & Y should not have incorporated accumulated differences in respect of the arrangements and the perpetual notes in their schedule of audit differences. In our view the appropriate amount to be included should be not the accumulated but the annual impact of any particular differences of opinion between the auditors and the Bank.

16.52 We were concerned to see very large offsetting misstatements in individual items included in the unders and overs schedule.

16.83 **We are concerned that E & Y appear to have misunderstood the way in which the difference in profit impact between the Bank's straight-line approach and the correct YI M method for the capital notes should be calculated. We would expect any computational differences between an auditor and a client to be resolved by discussion between them so that any remaining differences are ones of principle. We see this as an obligation on the part of both the auditor and the client, particularly where the client intends to rely for reassurance on the auditor's calculation of audit differences.**

16.84 We are drawing the attention of the NZSA to this situation and inviting them to consider whether they think further guidance should be given to their members with audit responsibilities.

17.0 FINANCIAL YEAR ENDED 31 MARCH 1992

Interim financial statements for the half-year ended 30 September 1991

The financial .statements

17.1 **For the half-year ended 30 September 1991 the Bank took a nil benefit from the arrangements. It continued to amortise $11 million of premium. It also used the existence of the arrangements as a basis for adjusting several line items in the published financial statements as follows:**

Interest income	**$6 million**
Other operating income	-$11 million
Provisions for doubtful debts	-$17 million

17.2 The imped which these adjustments, and the amortisation of the premium, had on the published statements, compared to the YTM method, was:

Profit and Loss No half-year ended 30/9/1991

	Bank	YTM	Variance	
Operating profit before provns and tax	**$145 mn**	**$183 mn**	-$38m	-20.WI.
Provisions for doubtful debts	**$40 mn**	**$57 mn**	**-$17m**	**-29.WI.**
Profit before tax and extraordinaries	**$105 mn**	**$126 mn**	-$21m	-167o/o

Balance sheet as at 30/9/1991

Shareholders funds	**$966 mn**	**$923 mn**	+$43m	+4.7o/o

17.3 **These financial statements demonstrate the effect on profits and shareholders funds of the reversal of the benefits taken in 1990. Profits are now understated and the overstatement of shareholders funds is diminishing.**

The appropriateness of the Bank's accounting treatment for the arrangements

17.4 The Bank did not match the benefits from the arrangements with their associated costs, being $11 million in amortised premium and $10 million in foregone interest. The Bank did not follow its own general accounting policy of matching costs and revenues.

17.5 For the reasons outlined earlier the Bank's accounting treatment did not accord with the substance of the arrangements or have authoritative support.

17.6 **Again the treatment did not accord with the advice of E & Y, which by now was that YTM was the proper method of accounting for the arrangements.**

17.7 **The treatment in the Bank's accounts was inconsistent with that followed in the preceding full year. In this half-year the Bank used the arrangements as a means of reducing the provisioning for doubtful debts and making compensating reductions in interest income and other operating income.**

17.8 **We conclude that the Bank's accounting treatment for the arrangements in the financial statements for the half-year ended 30 September 1991 was not appropriate.**

17.9 There was an overall incorrect reduction in pre-tax profit for the half-year of $21 million or 18.70/o of pre-tax profit for that half-year.

17.10 **The half-year financial statements are unaudited and accordingly there is no computation of "unders and overs". However it is reasonable to assume that the above profit understatement was offset by the overstated gain of $3.1 million (US$1.7S million @ 0.87) arising from the Bank's continuing erroneous treatment of the gain on the capital notes.**

17.11 **When the error on the capital notes is taken into account the profit understatement in the half-year to 30 September 1991 is reduced to $18 million, meaning profit before tax was 14.60/o lower than it should have been.**

Our view concerning the September 1991 financial statements

17.12 The profit understatement of $18 million is not, in **our view, sufficiently material to affect the truth and fairness of the results of the Bank for the period.**

17.13 We observe, however, that these financial statements included several **undisclosed adjustments to components of the Bank's profit and loss account and balance sheet. These adjustments were made notwithstanding the firm advice the directors of the Bank had by then received about the appropriate accounting treatment of the costs and benefits of the arrangements.**

17.14 Mr T.K. McDonald and Mr S.L. Maier were appointed to the Board in July/August 1991. The September 1991 financial statements were approved in October 1991. McDonald has said that he had no reason to make any enquiry as to whether the statements were incorrect by virtue of manors affecting the arrangements. We accept this statement unreservedly. We think it will also apply to Maier. It also applies in respect of the March 1992 financial statements of the Bank.

.Audlted flnanclal ntntemente for the year ended 31 March 1992_

A. *The_financial statements_*

17.15 Due to the amounts the Bank had claimed in the earlier years of the arrangements it was limited in what it could do in the 1992 financial year. The Bank included in its reported income for 1992 an amount of $6 million of benefits from the arrangements. This was credited to "other operating income..

17.16 The effect of this usage of the arrangements on the Bank's published financial statements included:

Profit and Loss A/c year ended 31/3/1992_

	Bank YTM_	**Variance_**
Operating profit before provns and tax	$287 mn $323 mn	-$36m -11.10/o
Operating profit before tax	**$241 mn $277 mn**	-$36m -13.0o/o

Balance Sheet as at 31/3/1992_

Shareholders funds	$1,046 mn $1,013 mn	+$33m+3.3o/o

*B. The appropriateness of the Bank's accounting treatment for the arrangements_*

17.17 The Bank took income benefits of $6 million into its financial statements, $36 million less than the costs of the arrangements in the same year. This meant that the Bank did not follow its general accounting policy of matching revenues and expenses.

17.18 For the reasons already explained the Bank's accounting treatment did not accord with the substance of the arrangements and did not have authoritative support. In addition to FASB 5, by this time the ICAEW exposure draft referred to in paras 10.17 to 10.23 had been issued. Both the auditors and Coopers had advised that the arrangements should be accounted for as an investment.

17.19 The treatment followed in the 1992 year-end financial statements was similar to that followed in the 1991 financial statements in that the benefits taken were

added to interest income

17.20 **We conclude that the accounting treatment used by the Bank to account for the arrangements in the financial statements for the year ended 31 March 1992 was not appropriate and did not have authoritative support.**

17.21 The resultant profit understatement of $36 million, compared to a "correct" pre-tax profit figure of $277 million appeared to be in a range which could be considered material.

17.22 Because of our awareness of the misstated income from the capital notes we decided first to review E & Y's schedule of audit differences.

(a) Our review of the summary of audit differences_

17.23 The "Summary of Audit Differences" prepared by E & Y is included as Appendix P to our report. It concludes that there was an overall understatement of the Bank's profit of $8.5 million.

17.24 The summary includes a profit overstatement on account of the arrangements of $16 million, being the accumulated influence the arrangements had had on the Bank's profitability from establishment to that point.

17.25 Our view is that the differences should only include the annual influences on profit since all previous variances had been offset in earlier years by other items. On this the proper measure of the effect of the Bank's incorrect treatment of the arrangements which should be recorded in the schedule is an understatement of $36 million.

17.26 **The** schedule also includes a profit understatement of $36.1 million which was E & Y's computation of the accumulated difference between the Bank and the auditors on the capital notes since they were put in place.

17.27 Our assessment with respect to the capital notes is that the influence for the year is a profit overstatement of $6.1 million (US$3.36 million @ O.SS).

17.28 We have already commented on the approach taken by E & Y to the construction of the unders and overs schedules.

(b) The Commission's revised schedule of audit differences

17.29 **Accepting E & Y's other adjustments, our revised schedule of audit differences becomes:**

Arrangements	-$36.0 million
Capital Notes	+$6.1 million
Other differences, net	+$ 7.3 million
Impact on Proflt before tax	**-$22.8 mutton**

C. ***Our views on the March 1992 financial statements***

17.30 **A profit understatement of $23 million is an understatement of 8.7% in relation to the Bank's corrected profit before tax and extraordinaries for the period. In our view this is not a material amount. In our view the truth and fairness of the** financial statements of the Bank for the year ended 31 March 1992 was not materially effected by the way the Bank accounted for the arrangements once other adjustments are taken into account.

D. The takeover offer from National Australia Bank Limited

17.31 **The 31 March 1992 financial statements were the latest statements available at the time of the offer for the shares of the Bank by a subsidiary of National Australia Bank Limited (-NAB`). Accordingly we questioned several directors on the profit understatement in those financial statements in view of that offer.**

17.32 The responsibility for provision of information to the minority shareholders rests with the directors of the Bank. In this case they appointed Baring Brothers Burrows & Co Limited (.Barings") to provide a report to the minority shareholders. A high standard of performance could also be expected from Barings in the circumstances.

a)Comments from directors_

The directors considered the profit understatement was not material. They pointed out that Darings, who had been retained by the Bank's independent directors to provide minority shareholders with an independent assessment of the reasonableness of NAB's offer and of the Bank's future sustainable earnings, would have factored the return flow of funds expected in March 1993 into their calculations.

b)Comments from Barings_

17.34 Darings made no mention of the arrangements in their reports to the Bank's directors although they referred at several points to making adjustments for "non-recurring items-.

17.35 **When assessing the Bank's recent financial performance, Darings included only the Bank's income statements for the years ended 31 March 1991 and 1992.** They said:

As a result of the restructuring programme discussed above, we believe that the Bank's profit history prior to 1991 is not relevant in assessing the future maintainable earnings of the Bank.

17.36 **Barings were asked by the Bank, following discussions with the Market Surveillance Panel of the New Zealand Stock Exchange, to provide additional written advice to shareholders on a number of supplementary matters in relation to NAB's offer, including:**

whether [NAB] has received, in the course of conducting its due diligence exercise on the Bank, information which Is non-public and which, if it were public, would, or would be likely to, lead a reasonable Investor to believe that the price offered by [NAB] is too low:

17.37 Barings' response to this question, as set out in its !suer of 29 September 1992 to the directors of the Bank was:

In our opinion.'
[NAB] has not received information In the due diligence process which would lead a reasonable investor to believe that the price offered by [NAB] is too !ow; and no information has been made available to [NAB] which would cause us to change our recommendation that the Offer is fair;

17.38 **We asked Barings for their comments on several matters in relation to their report to the minority shareholders of the Bank. They have informed us In a loner dated 8 March 1993:**

...The historical impact of the captive insurance transaction upon the Bank 's reported profitability In 1991 and 1992 had no bearing upon the future cash flow projections of the Bank, nor upon our DCF' valuation or assessment of the fa/mess of the Oner. However it should be noted that the enact of the arrangement as it related to 1993 was factored into our DCF valuation...

In our assessment of the value of the Bank, we also considered the valuation method based upon the capitallsation of future maintainable earnings ("FME"). As indicated in our report, this method is based upon

the derivation of future maintainable (core) earnings of the Bank. In this context, the captive insurance transaction Is a non-core item and consequently its Impact on the Bank's reported profitability for 1991 and 1992, was not relevant to our assessment of the future core maintainable earnings of the Bank.

*Discounted Cash Flow

17'.39 **With respect to the reasons why Barings did not consider information about the arrangements to be sufficiently material to influence the views of the reasonable investor about the share offer Barings advised:**

> ***...the impact of the captive Insurance transaction upon the Bank's recent histon.cal cost financial performance was not relevant to our valuation of the Bank, nor was it material in our assessment of the fa/mess of the oner. ... It was considered as a non-core non-maintainable item, which, aside from its residua/ cash flow impact in 1993, had no bearing upon, or relevance to, our valuation of the Bank. Accordingly we formed the opinion that this information, if it had been public, was not likely to have led a reasonable investor to believe that the pn.ca offered by [NAB] was too low.***

17.40 This reasoning was expanded on in a second loner dated 25 March 1993. In their loner Barings sot out their own accounting analysis of the BNZ's "future maintainable eamings". They demonstrate their point of view as follows:

	Bank YTM
1992 Operating Profit before tax	***$241m $277m***
Less Profit Impact of Accting treatment of Arrangements (which is a non-recurring item)	*{$16m)_ $20m_*
1992 restated profit before tax	*257~m $257m_*

The table demonstrates that the 1992 base for assessing future maintainable earnings of the Bank (assuming there were no other adjustments) was $257 m and this would be arrived at irrespective of

> *whether the Bank had accounted for the arrangements on a YTM basis or under the Bank's accounting treatment since the arrangements are <u>non-recurrlnq.</u> it is entirely specious to factor in a $20 m Increment to 1992 profits an.sing from a non-recum`ng item on the basis it is relevant in assessing future maintainable earnings.* [Original emphasis}

17.41 BGBW, for the Bank, have fully endorsed the Barings submissions as also representing their own views.

(c) <u>Our comment</u>

17.42 The effect of following the YTM approach is to treat the Bank's earnings from the arrangements as "core" interest earnings.

17.43 **Treating the Bank's investment in the "premium" as a straight-forward investment earning interest would have resulted in 02_t interest earnings for the Bank of $20 million in 1992. Instead there was a net cost of $16 million. <u>Both</u> those influences are non-recurring. The difference is a $36 million non-recurring pre-tax understatement in the year ended 31 March 1992. In the year ended 31 March 1994 the Bank will be able to earn a clear return on the reinvestment of the payment of $170 million it received on 31 March 1993. That will be part of the Bank's future core earnings.**

17.44 **While the negative, non-recurring influence on the Bank's pre-tax income for the year ended 31 March 1993 is only $20 million, not $36 million, because of the benefits of $22 million left to claim in that year, the difference in pre-tax income between the 1992 year and the 1994 year is $36 million.**

17.45 In our view Barings incorrectly assessed the impact of the arrangements on the future core earnings of the Bank.

17.46 Although we consider there was a $36 million non-recurring influence on the Bank's 1992 pre-tax income from the arrangements we do not believe that

influence, after taking into account other adjustments such as that relating to the capital notes, was material to shareholders when considering the reasonableness of the offer from NAB.

18.0 FINANCIAL YEAR ENDED 31 MARCH 1993

Interlm flnanclal statements for the half-year ended 30 September 1992_

The financial_ statem_ants

18.1 The amount remaining to be taken as income under the arrangements in the year to 31 March 1993 is limited to $22 million, which offsets the remaining amount of premium to be charged against profits in the same financial year.

18.2 Assuming that the Bank took $11 million of benefits in the half-year, all of which was included in interest income, the effects on the Bank's results would include:

Profit and Loss A/c half-year ended 30/9/92_

	Bank	YTM_	Variance_	
Operating profit before provns and tax	$149 mn	$159 mn	-$lOm	-6.30/o
Operating profit before tax and extraordinaries	$117 mn	$127 mn	-$lOm	-7.9%

Balance Sheet as at 30/9/92_

Shareholders funds	**$1,115 mn**	**$1,098 mn**	+$17m	+1.5o!o

The appropriateness of the Bank's accounting treatment for the arrangemants

18.3 **The amount of benefit taken in the half-year did not match the effective cost of the arrangements for the same period. Accordingly the treatment did not accord with the Bank's general accounting policy of matching revenues and**

18.4 **As discussed in previous sections, the Bank's accounting treatment for the arrangements did not record them according to their substance and was not in accordance with accepted accounting practice.**

18.5 We therefore conclude again that the Bank's accounting treatment for the arrangements was not appropriate.

18.6 There was a profit understatement of some $10 million arising from this incorrect treatment.

18.7 **This profit understatement would again have been partially offset by the impact of the Bank's incorrect treatment of the capital notes, which would have overstated income by approximately $2.7 million ($$USI.46 million @ 0.54). A $7 million profit understatement represents a variance of 5.Bolo from the appropriate level of profit.**

Our views on the September 1992 financial statements

18.8 These particular financial statements were released at a time to allow them to be considered at an Extraordinary General Meeting of the Bank held on 30 October 1992 to address a number of issues related to the NAB takeover offer.

18.9 **In the circumstances we would expect the directors of the Bank to have been meticulously careful to present a set of financial statements which were as accurate as they could make them.**

18.10 **Taking into account the purposes for which the Bank's September 1992 half" yearly financial statements were intended we find that the profit understatement was not sufficiently material to affect the truth and fairness of those financial statements for that period.**

19.0 DEBT SECURITY PROSPECTUSES ISSUED BY THE BANK UNDER THE SECURITIES ACT 1978

The requirements of the Act and Regulations

19.1 The BNZ is an issuer of debt securities for the purposes of the Securities Act. To meet the terms of the Act and the Securities Regulations the Bank has been required to register and distribute prospectuses for debt securities since 1 July 1988. The obligation to comply with the Act and Regulations are modified by the provisions of a Securities Commission exemption notice for registered banks as a class of "continuous issuers".

19.2 The construction of the Act is such that issuers of debt securities are required to register a new prospectus each six months, and this prospectus is required to contain the latest audited financial statements of the issuer plus, if the date of any deposit with the bank would be more than nine months after balance date, a set of interim financial statements, which need not be audited, in respect of the subsequent half-year. Appropriate comparative figures must also be included.

19.3 **The Regulations stipulate that a registered prospectus must contain certain prescribed information, including accounting information. Clause 16 of the Second Schedule of the Regulations provides that a debt security prospectus must contain:**

> ***16(1) An audited consolidated balance sheet of the group giving a true and fair view of the state of affairs of the group -***

whoa clause 27 requires prospectuses to contain:

> *27(1) An audited consolidated profit and loss account of the group giving a two and fair view of the results of the group --*

Clause 28 details a number of specific matters which must be included In a borrower's profit and loss account.

19.4 **Section S6 of the Act provides for certain civil remedies if in person suffers loss as a result of subscribing for securities on the basis of a prospectus which contains statements which are untrue. No question of civil liability relating to loss by depositors has been raised with the Commission.**

19.6 Section SS of the Act says:

> ***For the purposes of this Act -***
>
> ***(a) A statement included in an advertisement or registered prospectus shall be deemed to be untrue if -***
>
> *(i) It is misleading in the form and context in which it is included; or*
>
> ***(ii) It is misleading by reason of the omission of a particular which is material to the statement in the form and context in which it is included,'***

(b) ***A statement shall be deemed to be Included in an advertisement or registered prospectus If It Is contained therein,. or on the face thereof, or In any report, memorandum, or document accompanying the advertisement or registered prospectus or by reference Incorporated therein or distributed therewith.***

19.8 Regulation S(1) of the Regulations says:

If a statement required to be Included In a registered prospectus would be misleading if additional Information were not also Included, the prospectus shall also contain that additional Information.

19.7 **In section 12 of this report we reviewed the financial statements of the BNZ since March 1988. In this section we consider the Bank's debt security prospectuses.**

19.8 **The variances referred to in this section are the same as the revised figures we used in the preceding sections. Details of these variances can be found in Appendix K. However the comparisons are made against the amounts stated in the financial statements as included in each debt security prospectus. These financial statements are those of the "borrowing group", i.e. the BNZ parent only, rather than those of the normal consolidated group.**

Our review Bl each prospectus

Prospectus No 1 dated 21 June 1988

The financial statements

19.9 **The arrangements were entered into in March 1988. The Bank paid a premium of $109.8 million, almost all of which was held as a pre-paid expense. No disclosure was made of the existence of the arrangements or of the prepayment.**

19.10 **Clause 9 of the Second Schedule requires a prospectus to include:**

> ***In relation to every material contract entered Into by any member of the borrowing group at any time in the 2 years preceding the specified date (not being a contract entered into in the ordinary course of business of that member), -***
>
> ***a)Its date; and***
>
> ***b)The names of the parties to it; and***
>
> ***c)Its general nature.***

19.11 **In 1988 the Bank had total assets in excess of $16 billion. The arrangements, which involved the investment of $110 million, while probably not being entered into in the normal course of the Bank's business, were not material in relation to the Bank's total assets.**

19.12 We have stated earlier that we are satisfied that the Bank did not understate the amount of provisioning for doubtful debts made for the year to 31 March 1988 as a result of it having entered into the arrangements. The only impact on the Bank's profit was the cost of one day's premium, $82,000.

Our finding in relation to Prospectus No 1

19.13 **We find that, in respect of the influence of the arrangements, the Bank's debt security prospectus No 1 did not omit any material manors which should have been disclosed.**

Prospectus No 2 dated 22 December 1988

The financial statements

19.14 **Debt security prospectus No 2 incorporated the Bank's half-yearly accounts to 30 September 1988. These accounts included half-yearly amortisation of the premium and a compensating -claim- benefit of $20 million.**

Our findinq in relation to prospectus No 2

19.18 **We have concluded at para 14.20 that the influences of the Bank's use of the arrangements on its financial statements for the half-year ended 30 September 1988 were not sufficiently material to effect the truth and fairness of those financial statements, although there were undisclosed impacts on the level of the Bank's provisioning for doubtful debts. We find the same with respect to the financial statements included in this prospectus.**

Pro8pectufr No 3 dated 16 June 1989

Comment and our findinq in relation to prospectus No 3

19.16 **Prospectus No 3 included the financial statements of the Bank for the year ended 31 March 1989. As already stated in paragraph 14.26, in our view the influence of the arrangements did not affect the truth and fairness of those financial statements. We find the same with respect to the financial statements** included in this prospectus.

Prospectus No 4 dated 21 December 1989

The financial statements

19.17 **Prospectus No 4 included the Bank's half-yearly accounts to 30 September 1989. Those accounts showed an operating loss before tax of $30 million for the BNZ parent, and profit before tax for the BNZ Group of $18 million.**

Our finding in relation to prospectus No 4

19.18 On the understanding that the Bank took benefits of $20 million in this period which were offset against the provisions for doubtful debts, we have concluded at paragraph 15.5 that the Bank's use of the arrangements did not affect the truth and fairness of the Bank's financial statements for the half-year to 30 September 1989. Similarly it did not affect the truth and fairness of the financial statements included in this prospectus.

Prospectus No 5 dated 25 June 1990

The financial statements

19.19 Prospectus No 5 contains the Bank's financial statements for the year ended 31 March 1990. In that year the Bank `claimed` $94 million under the arrangements which, in our view, had a significant impact on a number of items disclosed in the prospectus including:

Charge for provision for doubtful debts of $165 million was $54 million lower than it should have been;

Operating profit before tax and extraordinaries, after adjustment for revised

'anders and overs` was $64 million higher than it should have been;

The level of provisions for doubtful debts in the balance sheet was $94 million lower than it should have been;

The level of the Bank's shareholders' funds, at $716 million was (after adjustment for our amended unders and overs schedule) $55 million higher than it should have been.

Our findings in re|ation to , Prospectus ,No 5

19.20 **We have already expressed our view in paragraph 15.152 that the Bank's published financial statements for the year ended 31 March 1990 did not give a true and fair view of the affairs of the BNZ at that date or for the period then ended. We express the same view concerning the Profit and Loss account included in Debt Security Prospectus No 5. In our view the Bank's profit and loss account did not present a true and fair view of the results of the Bank for the period then ended.**

19.21 As a consequence we consider that Debt Security Prospectus No 5 did not comply with the requirements of clauses 16 and 27 of the Second Schedule of the Regulations. However we observe that no depositor has been prejudiced as a result of subscribing for any securities on the basis of this prospectus and that it was issued some three years ago.

Prospectus No 6 doted 19 December 1990.

A. The financial statements

1.9.22 Prospectus No 6 incorporates the Bank's interim unaudited financial statements for the half-year ended 30 September 1990. The prospectus included details

of the Bank's "Adbro" restructuring, although the full financial consequences of that restructuring were not incorporated in the Bank's financial statements` until the annual accounts to 31 March 1991.

19.23 The financial statements in the prospectus included a change of accounting policy with respect to the treatment of the deferred tax asset (resulting In a downwards adjustment of $308 million in the Bank's opening retained earnings).

19.24 We noted in paragraph 16.12 of our report that, assuming the Bank took half the planned benefits for the year to end March 1991 in the half-year, and after adjustment for the capital notes, there was a profit overstatement of $13 million before tax. There would also be an overstatement of shareholders funds of $64 mOlion.

19.25 We concluded that, although these overstatements were possibly material, their effect would be overshadowed by the information concerning significant doubtful debt provisioning (an additional $797 million) to be made in the next full year's financial statements.

19.26 The impact of the arrangements on the financial statements in the Bank's debt security prospectus is the same, in absolute terms, as that on its published financial statements. These impacts are:

Profit before tax and extraordinaries of $55 mullah was $13 million higher than it should have been;

Shareholders funds of $453 million were $64 million higher than they should have been.

B. *Our findings in relation to the financial statements in prospectus No 6*

19.27 **In our view the materiality of these variances has to be considered against the background of the restructuring of the Bank which was going on at that time. We conclude again that, considered in this light, the variances were not of such materiality as to affect the truth and fairness of the Bank's financial statements for the half-year ended 30 September 1990 included in this prospectus.**

C. *The restatement of specific provisions*

(a) The statements in the prospectus

19.28 **During the course of 1990 the Bank decided to restate its disclosed level of specific provisions for doubtful debts. This arose as a consequence of a change in the accounting treatment of past benefits taken under the arrangements. This lead to a misunderstanding between the Bank and the Registrar of Companies at the time of registration of Prospectus No 6 in December 1990. We found it necessary to review the circumstances of this misunderstanding.**

19.29 **While the Bank's 31 March 1990 financial statements, as incorporated in prospectus No S, had shown the level of the Bank's specific provisioning as $893 million, the statement in debt security prospectus No 6, under the heading "Material Contracts" said that:**

> *Bank of New Zealand had already recognised and provided for a restated amount of $955.4 million as at 31 March 1990.*

19.30 **The difference of $63 million mainly comprised the level of the earlier benefits taken under the arrangements which had been offset against the Bank's specific provisions for doubtful debts.**

19.31 **Note 6 'Advances and Other Accounts" on page 17 of the prospectus includes the following statement:**

> ***The amount of $955.4 million in respect of doubtful debts referred to on page 5 of this prospectus results from the fact that this amount takes account of adjustments which have been made subsequent to the balance date including debts not transferred to Adbro, exchange fluctuations and debts for which reimbursement will be made from third parties through & subsidiary company.***

This statement that "reimbursement will be made from third parties through a subsidiary company" is the only published reference to the arrangements known to the Commission prior to the statements in the House of Representatives in 1992.

(b) Documents provided by the Bank_

19.32 An internal Bank memorandum from Purvis to Pyne, dated 17 December 1990, headed "Prospectus No.6" says:

> ***Two issues remain unresolved as regards the finalisation of the above Prospectus for registration.***
>
>> ***The first issue relates to the discrepancy between the balance of specific provisions at 31 March 1990 as detailed in the Annual Report and last prospectus of $893.gm for the parent company and the level of provisioning restated in the restructun'ng transaction of $955.4 m.***
>
> ***The major difference between the two amounts is the debt insurance total/ing $94 m.***
>
> ***We have experienced great difficulty with Mr Graeme Casse/ls of the Companies Gffice in agreeing appropriate wording to explain the variance - to date we have not used such terms as 'indemnity ' or 'debt insurance'.***
>
> ***Attached are two wordings which we consider factually explain the situation. Richard McLean of Buddie Findlay prefers the statement:***
>
>> ***-reimburse.ment from third parties will be made through a subsidiary company.***

In his opinion the other statement:

"reimbursement will be made from a subsidiary company"

may be misleading by the omission of a particular, section 55 of the Securities Act says that a statement may be misleading by reason of the omission of a material particular.

Peter Gerty of Ernst & Young has also reviewed both wordings and while both would be acceptable, his preference is also for the fuller disclosure.

Either of the proposed statements could result in further questions about the source of the reimbursements. This could in turn lead to the disclosure that there have been $200 million of further bad debts which have never been disclosed as such in the Bank's accounts.

Urgency is now required if we are to have the prospectus registered, before the E G.M

19.33 The final wording was settled after this memorandum had been sent. We understand that individual directors of the Bank were contacted by Purvis, at the request of Pyne, to clear the final wording before the prospectus was registered.

19.34 The restatement of the level of specific provisioning was referred to again in May 1991. A memorandum dated 23 May 1991 from Shelton to the Audit Sub-committee of the Board, stated:

The transfer of specific provisions to Adbro has required a restatement of the comparative balance sheet figures on a gross basis. This may lead to questions from analysts, and the Companies Office with respect to the next prospectus. In anticipation of this, the manor has previously boon positioned with the Companies Office by including In the last prospectus the following explanatory comment...

[Repeats the paragraph set out in paragraph 19.31 above}

We do not see any particular problem but It may become difficult to explain the movements in specific provisions without disclosing the existence of the debt insurance.

19.35 **We questioned a number of directors and officers of the Bank on this manor. We also questioned Mr Graham Cassells, Senior Investigating Accountant, of the Wellington ONice of the Registrar of Companies.**

(0) Evidence to the Commission

19.36 Sadler, when asked what he thought was the basis of the concern expressed in Shelton's note about disclosure of the arrangement, said at p.254:

> ***Because it would |us! lead to another note. Here we have something else to put in as a specific note in the accounts. You try and keep those to the minimum. ...***

19.37 **Later Sadler was asked if it was not a manor of importance to him whether or not, in a note to the prospectus or otherwise, reference was made to the existence of the insurance policy. He replied at p.256:**

> ***No because the use of the policy was Immaterial.***

19.36 **Purvis, who was primarily responsible for the preparation of the Bank's debt security prospectuses, was asked if he know, at the time of the problems with registering prospectus No 6, of any reluctance on the part of the Board to disclose the existence of the arrangements. He said at p.1303:**

> ***rm not `sure if reluctance was the right word, but certainly It wasn't disclosed.***

19.39 Purvis was asked whose decision it was not to disclose the existence of the arrangements. He said at p.1304:

> ***...the use of the debt Insurance was within the bounds of what It had been established for in 1988 reaffirmed by the Board In 1989, It hadn't been disclosed at those points in time and i think ... there was a perception it would create just as many difficulties as not disclosing So i think at the***

end of the day weighing all those up and with the concurrence of the auditors and our legal advisers, I think the genera/ consensus was that we didn't need to disclose It.

19.40 **Purvis was asked if this was the consensus of management. He said at p.1304:**

> ***/ think It was the consensus of management and 1 think It was also consensus with the audit sub-committee and as 1 had previously advised the [Commlss/on], we did review our financial statements and all the notes to the accounts fully with the Committee, and disclosure of the debt insurance was raised with them, and they were aware that it was not disclosed.***

19.41 **Purvis was asked if he was aware of any policy on the part of the Board or the audit subcommittee that disclosure of the insurance arrangements should not be made in the company's accounts or prospectus. He said at p.1316:**

> *I think the directors wanted to continue their previous policy that it was not disclosed, yes.*

19.42 **Purvis was asked if this was a policy already known to him or recognised by him before he encountered the problems with Mr Cassells, he said at p.1316:**

> *Disclosure of the debt Insurance was debated with the 1990 accounts with the change in the accounting treatment and the directors' decision was made not to disclose It at that time. ....all I am saying Is that 1 went back to the policy that was In place when the annual accounts had been provided and continued on the basis that that policy was* st/// *in place, and from that basis this note was written to the Managing Director and subsequently to all the Board.*

19.43 **Later, when asked if the Bank was deliberately seeking to mislead the Registrar of Companies, Purvis said at p.1319:**

> ***We/I from my persona/ ... involvement in the process 1 don't think it was a deliberate process that we were trying to thwart the Registrar. We certainly didn't tell the Registrar of the existence of the debt Insurance. ...***

19.44 Phillips, who was primarily responsible for liaison with the Registrar, was asked what were the difficulties he had in explaining the discrepancy in the levels of specific provisioning which had been picked up by the Registrar's staff. He said at p.1023:

> *...I.t was acknowledged that the debt Insurance was, or had not been disclosed In previous annual reports or prospectuses. ...It hadn't been disclosed previously and [It] would be appropriate not to disclose at that time. So, but I never had any written instruct'on, / never saw any documentation that said categorically this Is not to be disclosed to anybody. That's just the feeling that I had...*

Ig.45 The Bank's initial explanation to the Registrar was that the discrepancy in the provisioning figure primarily related to foreign exchange losses, also that the figure did not take account of miscellaneous provisions held in the item -bills payable and other liabilities'. Phillips was asked if he agreed that this disclosure was less than frank. He said at p.1026:

> *Yes. There certainly in material terms you are right. / guess the answer Is yes. Those other factors were part of It, but they weren't the material difference.*

19.46 Phillips was asked if the final wording which was put forward had come from the Bank's solicitors, Budfin. He said at p.1027:

> *I don't know the answer to that. / just can't recall. ...Char/es [Purvls] and I sat down with Richard McLean [Budfin] for some hours that night discussing the various options for wording. ...*

19.47 Shelton, when asked why the Bank appeared to be reluctant to disclose the existence of the insurance arrangement, said at p.881:

> ***We// as /'ve said the policy up ti// that stage had not been to disclose it so I had been in effect highlighting that we may need to again not because It was necessarily legally necessary or accounting policy necessary but just because If we didn't we might have two figures without a bridge between them which was not a desirable situation.***

19.48 Asked why the Bank had a policy of not disclosing the arrangements,.Shelton said at p.881:

> *The policy was In place before ` I arrived. The Bank's genera/ policy had been to disclose what was required to be disclosed in terms of discussions with auditors and it was just the status quo that there hadn't been, ...*

19.49 **Pyne, who was Managing Director at the time of registration of prospectus No 6, was asked if there was a Board instruction or known Board policy at the time of registration of that prospectus that the existence of the policy should not be indicated. Pyne responded at p.1557:**

> *I think the Board was following, / am not sure that there was any policy decision I mean It was certainly understood by all Board members and by members of the finance area that the Board considered it not necessary to disclose it.*

19.50 Pyne was referred to Shelton's memorandum (see para 19.34) and asked if he thought this indicated a reluctance on the part of Bank management to- reveal the existence of the policy. He replied at p.1566:

> *No / think that to me that Indicates an intention to follow with the consistent policy of not disclosing it.*

Asked why not take the opportunity to disclose the existence of the arrangement in the No 6 prospectus, Pyne said at p.1567:

> *We// It hadn't been disclosed before and we were following a consistent policy since 88 In not disclosing it.*

19.51 **Garty was asked about the Bank's policy on disclosure of the existence of the arrangements. He said at p.426:**

> ***My understanding of it at 1990 was still that the directors and man.agement did not want to put a note disclosing the existence or the use of it.***

Asked if he had any doubt about the Bank's attitude Garty said at p.427:

> ***We// I think if you look at the prospectus No.6 you'd had to make that conclusion yes.***

19.52 **Cassells confirmed he was never told of the existence of the insurance arrangements. He eventually accepted the wording put forward by the Bank. He said he did this following discussions with Garty of E & Y. Cassells, after outlining difficulties in getting in touch with Garty, said at p.598:**

> ***...eventually when he came back to me he sort of assured me that there were no real problems. 1 didn't get any real explanations ... but 1 felt confident enough that if he was happy as auditor then I was happy...***

(d) Submissions on behalf of certain directors of the Bank_

19.53 RMcV, on behalf of certain directors, has submitted:

> ***It is quite wrong and misleading to infer that there was a deliberate "policy" by the board of non-disclosure of the existence of the insurance. The efforts made by the staff arose from the fact of previous non-disclosure, and a "feeling" by some staff members that it was not to be disclosed Mr Phillips, who was responsible for the liaison with the Registrar, clearly stated that he had no instructions about non-disclosure.***
>
> ***The initiative for non-disclosure did not come from the board, but from the stan. Of their own initiative, they undertook the wording exercise with the help of the Bank's legal advisers. Although some of the initial responses to the Registrar by eta# were evasive and less than frank, that was not driven by or even known to the board. There is a real danger that such actions by staff are imputed to the Board's level of knowledge. The board***

did not know. In fact it is most unclear whether board members were even properly informed about the issue at all.

It Is clear that none of any underlying staff concerns about secrecy or any positive "policy" of non-disclosure arose from or were raised at board level. The directors were simply presented with the prospectus with a proposed note, were told that it was to deal with a post Adbro discrepancy, had been approved by the auditors, lawyers and Registrar, and they accepted the advice.

D. *Our views on the Bank's disclosures in prospectus No 6*

19.54 The Registrar's staff observed a discrepancy between the amount of the Bank's specific provisions as described in its press release and as disclosed in draft prospectus No 6. The Bank was required to explain this discrepancy. It related to a variance which had arisen from the accounting application of benefits under the arrangements in prior periods.

19.55 **The Bank could have taken the opportunity to disclose the nature and previous treatment of the insurance arrangements at that time. Instead staff went to considerable lengths to devise a wording which they thought covered the situation and yet avoided any reference to.debt insurance- or-indemnity-.**

19.56 We are satisfied on consideration of all the evidence that it was a souled and consistent policy of the Bank not to disclose the existence of the arrangements to its shareholders or depositors.

19.57 Did prospectus No 6 contain an -untrue" statement? In paragraph 19.5 we set out the provisions of section 55 of the Act relating to the definition of "untrue' statements in a registered prospectus. Of particular relevance is subparagraph (a), which deems a statement to be untrue if:

(i) *It Is misleading in the form and context in which it is included; or*

(ii) *It is misleading by reason of the omission of a particular which is material to the statement in the form and context in which II Is included;*

19.58 **The relevant statement in the prospeotus is:**

...and debts for which reimbursement will be made from third parties through a subsidiary company.

19.59 It was prepared in oonsultation with the Bank's lawyers and auditors who both supported it. The statement does not:

(a) **refer to the existence of and desoribe adequately the material terms of the doouments which were used as a vehiole through which these "reimbursements" were to be made; nor does it**

(b) **acknowledge that the "reimbursements" are being made from the prooeeds of the investment, at interest, of a substantial sum of the Bank's own resouroes.**

19.60 **However, in the `oontext in which the statement was used, we do not consider there was an "untrue statement" for the purposes of the Aot. An inoomplete explanation of the ohange in the opening level of the Bank's speoifio provisions for doubtful debts was unlikely, in our view, to have a material bearing on how a reader of the prospeotus would have viewed the finanoial oondition of the Bank at that time.**

Prospectus No 7 dated 25 June 1991_

The_ Financial Statements

19.61 **Prospectus No 7 contained the Bank's financial statements for the year ended 31 March 1991. During that year the Bank utilised $38 million of the benefits under the arrangements. This had a relatively neutral influence on the Bank's overall profitability although the level of shareholders' funds remained overstated.**

19.62 In terms of the balance sheet included in prospectus No 7 the principal impact was:

> Shareholders funds of $703 million were overstated by $57 million (after taking account of`unders and overs.).

Our finding concerning prospectus No 7_

19.63 **In paragraph 16.22 we expressed our view that the influence of the arrangements on the Bank's financial statements for the year ended 31 March 1991, while significant in monetary terms, was not sufficiently material to affect the truth and fairness of those financial statements. We find similarly with respect to the financial statements in prospectus No 7.**

*Change in Accounting Policy_*

19.64 During this period the Bank received advice from Coopers in its Operational Review report, and from E & Y, that it was not following the correct accounting treatment for the arrangements. The Bank also received advice concerning whether or not it should make a prior period adjustment in its accounts to

reflect the previous misreporting of the arrangements

Our finding in relation to the change in accounting policy

19.68 In our view the Bank should, at that point, have changed its accounting policy for the treatment of the arrangements.

19.66 We believe the Bank's actions in circulating prospectus No 7 should be looked at in the light of the advice the directors had by then received from both Coopers and E & Y that their method of accounting for the arrangements was no longer in accordance with best practice. The Bank had an opportunity, at a time when a major restructuring provision was included in the accounts, to also pass the adjustments to correct for the misreporting of the arrangements. It chose not to do so.

Prospectus No 8 dated 13 December 1991

The financial statements

19.67 Prospectus No 8 incorporated the Bank's financial statement for the half-year ended 30 September 1991. During that period the Bank took a nil net benefit from the arrangements but made adjustments to several line items in the accounts.

19.68 Overall, when compared to the YTM method, and adjusting for the capital notes, the impact on the Bank's financial statements was:

Profit before tax and extraordinaries, at $88 million, was $18 million lower than it should have been.

19.69 **The impact of the low utilisation of the loss insurance on the balance sheet was to reduce the previous overstatement of shareholders' funds by $16 million. This meant that:**

Shareholders' funds of $743 million were $41 million above what they should have been.

Our findings in relation to prospectus No 8

19.70 **In our view the influences of the Bank's use of the arrangements on its financial statements for the 6 months ended 30 September 1991 were not sufficiently material to affect the truth and fairness of those financial statements.**

Prospectus Ne 9 **dated 26 June 1992**

The financial statements

19.71 **Prospectus No 9 is the last prospectus issued by the Bank prior to it sale to NAB. It includes the Bank's financial statements for the year end 31 March 1992.**

19.72 The Bank used $6 million of the claim value of the insurance arrangements in the year ended 31 March 1992. The effects of this utilisation were:

The Bank's net profit before tax and extraordinaries of $160 million, was, after adjustment for revised 'unders and overs', $23 million understated.

The Bank's shareholders funds' of $731 million were $24 million overstated.

Our findings in relation to prospectus No 9

19.73 **In our view the understatement of the Bank's profitability is not sufficiently material to affect the truth and fairness of the Bank's financial statements for the year ended 31 March 1992 as published in the prospectus.**

PART
Y_

M8SCELL .ANEOUS MATTERS_

20.1 During the course of our enquiry we did not find any evidence to suggest that any director or officer of the Bank or of any shareholder of the Bank, or any member or employee of the auditors or legal advisers to the Bank, had committed any offence or conspiracy of a fraudulent nature in relation to the putting in place, administration or accounting treatment of the arrangements.

21.0 BREACH OF FIDUCIARY DUTY_

21.1 We have considered whether there were any circumstances in which directors of the Bank with conflicts of interest may have been in breach of any fiduciary duty to the Bank.

21.2 From May 1989 to November 1992 the Bank had two major shareholders, the Government of New Zealand and Capital Markets Limited ("CML`), later Fay, Richwhite & Co Limited. ("FRL").

21.3 Following CML's acquisition of in stake in the Bank in May 1989 that company nominated three directors, Fay, Congreve and Mr G.T. Ricketts ("the FRL directors`) to the Board of the BNZ.

21.4 It has become apparent during our enquiry that the FRL directors took a close interest in the running of the Bank since their appointment to the Board. Fay was the chairman of the Operational Review Committee established in late

1990. On their own evidence the FRL directors of BNZ spent a great deal of time at the Bank and participated in numerous formal and informal meetings.

21.5 **We were told that the FRL directors of BNZ ,were assisted by three members of the staff of FRL, John Laird, David Boning and Henry Tait, on a full time basis. These three staff members signed confidentiality agreements with the Bank and, according to Fay and Congreve, operated within the offices of FRL behind a permanent Chinese Wall.**

21.6 **We were told that some of the FRL directors of BNZ, the three FR staff members, Pyne and Shelton met in Auckland in March 1990 as part of the Bank's budget and planning process. We understand that that group developed various scenarios covering many combinations of profit outcomes, including the implications of the use of the benefits under the arrangements.**

21.7 We did not think it was inappropriate for Pyne and Shelton to confer with FR staff in circumstances of strict confidentiality as described. The BNZ investment was a very large one for CML/FRL and it was not unreasonable for FRL directors of BNZ to seek logistic and analytical`support from FRL. It is critical that the FRL directors of BNZ should recognise their fiduciary obligation to all shareholders of BNZ in this process. We saw no evidence to suggest that the process had been misapplied.

21.8 We questioned other directors about the FRL influence on the affairs of the Bank. Sadist , who was an independent director on the Board, was asked to comment on whether there was any intrusion he would regard as improper in the affairs of the company by either of its substantial shareholders, for example, in the process of setting provisions, administering the arrangements, determining the profit for the year or recommending any dividend payment. He said at p.278:

No none at all. I can be very forthright. ... / think there was one little attempt to screw the scrum a wee bit In the first meeting [after the introduction of Fay Richwhite as a major shareholder} *and It got |umped on and from the viewpoint of Fay Rlchwhlte exemplary behavlour and we're very lucky to have the quality of directors that we had there. Goon Rlcketts in particular his standing, judicial and his way of thinking and didn't see things from an individual shareholder viewpoint and Robin Congreve similarly and Michael Fay /'ve no complaint at all. The great benefit of Michael Fay was in fact the energy and thinking that he brought to how do we make this Bank work, how to make It go and he was ire.mendous.*

21.9 **He added that the only intrusion over the period of his service as a director related to the establishment of the Operational Review Committee, a committee of directors, in late 1990. That was an initiative of the Government. In Sadler's** words at p.276:

SO that was It that was good for the Bank.

21.10 Pyne was questioned about the 1990 profit result and its proximity to the merger of FRL and CML. He was asked if that merger had been considered at all when looking at the Bank's profit position. Pyne said at 1534:

Absolutely not. I will say and I am under oath that at no time that / was managing director of that Bank did any director or shareholder and that includes the Government in any way act to influence the Bank's results. There was never any indication at the Board table, all decisions at the end of the day were a consensus decision, we never had to vote on anything and those decisions were always made at the Board table and / never saw any indication of an attempt to Influence that situation. No.

21.11 We consider that there was no evidence of a breach of fiduciary duty on the part of any director of the Bank in relation to the arrangements.

22.0 A8PECT8 OF THE ADMIN I8TRATION OF THE ARRANGEMENTS

22.1 Our enquiry into the arrangements has been more prolonged than it needed to be because of a number of unsatisfactory aspects to the manner in which they have been administered by the Bank. Particular points of concern for us have been:

Ca) that the Bank did not obtain legal or audit opinions relating to the nature of the arrangements and was unable to tender documents to us in relation to this matter;

(b) there was a lack of certainty about who within the Bank was responsible for administering the arrangements. Clack appears to have been mainly responsible for negotiating the arrangements, but it was not clear which department of the Bank should take responsibility thereafter. The accounting section in due course acknowledged responsibility for making the claims and paying the ongoing annual fees but there appears to have been some confusion about this.

(c) the Bank did not make claims under the arrangements for the income benefits taken Into its financial statements. The only claims which were made were in respect of payments due to the Bank under the payments schedule forming part of the arrangements, that is $10 million at the end of March 1990, 1991, and 1992 and $170 million at the end of March 1993.

The accounting section has been responsible for making the claims but the manager responsible, Phillips, told us that he had never seen the contract documentation.

Phillips, Purvis and Dowland each told us that their understanding was that by giving "indemnity notices", which specify the debts and investments covered by the policy, the Bank was making claims.

Garty of E & Y was aware that the Bank was not making claims when income benefits were being recognised in the Bank's financial statements but seemed unconcerned. He said at p.509:

> ***... given the content of what the [policy] was it [was] all a bit meaningless...***

(d) The Bank did not pass journal entries in its main accounting ledgers in 1989 and 1990 to record the income benefits of $40 mOlion and **$54 mOlion offset against the specific provisions for doubtful debts in those years. Instead the specific provisioning schedules were reduced by the amounts taken under the arrangements and net entries were passed.**

This situation was only remedied in 1991 when the Adbro restructuring was undertaken and the Bank's specific provisions were restated. This restatement of specific provisions was the source of the difficulties encountered with the registration of debt security prospectus No 6 when the Registrar's staff detected the discrepancy.

The accounting staff described their failure to pass the full entries when due as being the result of "sloppiness". The Commission accepts this explanation and concludes there was no ulterior motive to the Bank's actions.

23.0 REPORTING TO THE RESERVE BANK OF NEW ZEALAND

23.1 It has not been a purpose of our enquiry to scrutinise the Bank's compliance with the requirements of the Reserve Bank of New Zealand ("RBNZ") as prudential supervisor of the Bank. Nonetheless we did make limited enquiries of the Governor of the RBNZ, Dr D.T. Brash.

23.2 The BNZ first became subject to formal conditions of registration, including & capital adequacy ratio, on 14 June 1990. The Bank has published details of its capital adequacy ratios in its Annual Reports since 1991. The Bank has always been shown as having exceeded its ratio requirements.

23.3 In our report we have expressed our view that the Bank's pre-tax profits in 1990 were overstated by some $64 million (before tax and extraordinaries). Based on the Bank's level of capital reported at that time we are satisfied that the consequential adjustment of around $55 million to the Bank's tier one capital would not in itself have put the Bank below its prudential requirement.

PART_VI_

CONCLUSIONS AND REFERRALS

24.0 CONCLUSIONS

Nature o rangemente_

24.1 In March 1988 the BNZ entered into certain arrangement8 through it8 8ub8idiary BNZS whereby !08888 of up to $200 million on debt8 owing to the Bank occurring over a five year period were de8cribed ac being in8ured with e Dutch in8urance company BV, which in tum rein8ured 90% of it8 rick with EPUL, a member of the EPI group. BV Wac nominally owned by Kredietbank SA of Luxembourg, an a88ociate of a major Belgian bank.

24.2 **The Bank paid a 8ingle cum of $109.8 million to EPBC from which a premium of $108.9 million wa8 paid to BV to cover the full five year period of the arrangement8. The proceed8 of thi8 premium were initially inve8ted in zero coupon bond8 i88ued by BNZF and 8everal month8 later were reinve8ted in term8 of a depo8if agreement with the major Japane8e bank DKB. The maturity date8 of the bond8, and of the payment8 due under the depo8if, were:**

	$ mn_
31 March 1990	10
31 March 1991	10
31 March 1992	10
31 March 1993	170
	200

24.3 **The bond8 'and later the depo8if were held by EPHKTC, another EPI group company on certain tru8t8 which the director8 of the Bank were told were for the benefit of the Bank.**

24.4 **It was agreed that payments in settlement of any claims would be made only in accordance with the maturity schedule of the bonds/deposit.**

24.5 The Bank recognised as income in its financial statements the following benefits taken under the arrangements:

	$ mn_
Y/e 31 March 1989	40
Y/e 31 March 1990	94
Y/e 31 March 1991	38
Y/e 31 March 1992	6
Y/e 31 March 1993	22
	200

The Bank did not make claims corresponding to these income benefits. Instead, the Bank made only the following formal claims, in the form specified in the contractual documentation:

	$ mn_
30 March 1990	10
26 March 1991	10
31 March 1992	10
25 March 1993	170
	200

These claims closely preceded or coincided with the dates on which it had been agreed payments would be made. Payment of the claims .by the Bank was covered by the funds from the maturing investments.

24.6 The arrangements were facilitated by the EP group of companies which over the five years of the arrangements received fees from the Bank of around $1.15 million. In addition the Bank incurred other professional fees and expenses, including the costs of capital|sing the Dutch insurance company and payments to the nominee directors of BV, in the order of $0.5 million.

24.7 Kredietbank had a "put" option over its shares in BV back to an EP group company. In other words Kredietbank could, if it wished, require the EP group company to take back the ownership of BV. To our knowledge this option was never exercised.

Entry Into the arrangements

24.8 The directors of the Bank first learned of the proposal for the Bank to enter into the arrangements in the agenda papers for a board meeting on 17 March 1988. The decision of that meeting was to refer the matter for approval to a sub-committee of the Board comprising, for convenience, two of the Wellington.. based directors of the Bank including Campbell as chairman. The other member of the sub-committee, which met on 30 March 1988, was Bayliss.

24.9 The directors were told that the principal purpose of the Bank entering into the arrangements was 'income smoothing'. The arrangements were available to protect the Bank from the one-off "hit" which might arise over the duration of the arrangements. The directors were informed that the Bank's auditors and legal advisers had been closely involved with the development of the arrangements and had endorsed the validity and viability of the arrangements "for the purposes intended'.

24.10 **Our finding is that no discussions took place with the auditors before the afternoon of the day on which the Bank entered into the arrangements and the auditors were not then asked to advise on the validity or viability of the**

arrangements. With respect to the Bank's legal advisers our finding is that they were not asked to give advice on the proposed use of the arrangements, in particular, for the purpose of "income smoothing". We find that the directors were misinformed by the management as to the involvement of the Bank's auditors and legal advisers.

24.11 We noted that the same partners of Budfin accepted instructions from both the Bank and the EP interests in respect of the arrangements. It appears that the Board was not informed of this. In our view it would have been prudent for the Bank to have required separate firms of solicitors or at least different partners of the same firm to act for the parties on the different sides of the transaction in the particular circumstances of this case.

?4.12 We consider that the directors should have been informed of the level of fees payable by the Bank and should have been required to approve the.

24.13 In our view the adequacy and level of clarity of the information provided to the Board fell well short of the standard the board was entitled to expect for the purpose of deciding whether to commit the Bank to arrangements of such size and complexity.

24.14 We have been critical of the clarity of the information provided. In addition, the memorandum submitted to the sub-committee of the Board, and later the full Board, omitted some details, including the put option. Nevertheless, by the time the subcommittee minute reported that the decision had been made to proceed with the arrangement, it is our view that the directors had sufficient information given them to appreciate that the arrangements were little more than a .moneygo-round' with the Bank at their conclusion getting its own money back with accrued interest. it is apparent from the evidence and the documents ,that at least two directors in 1988, Lojkine and Pearson, had a proper appreciation of the true nature of the arrangements.

24.15 **While we do not consider "income smoothing" to be a proper reason for the Bank to enter into an arrangement of this size and coat we are satisfied that the directors of the day approved the Bank entering into the arrangements on the basis:**

(a) That there was no risk of the Bank losing its funds. The directors of the day were satisfied that, in any eventuality the Bank would always be able to receive the full $200 million back, by appropriate **claims under the arrangements;**

(b) That decisions on use of the benefits available under the **arrangements would always remain within the control of the directors rather than the Bank's management.**

24.18 The essence of the arrangements was that a sum in the order of $110 million was invested in securities yielding $200 million by the end of five years. There was interest of $90 million earned by the Bank over the period. The objective of "income smoothing" can be expressed at the two opposite extremes of the practice, by either:

(a) Saning aside $22 million of the Bank's profits in each of the first four years of the arrangements, recognising none of the foregone interest over that period, thereby depressing the Bank's reported income for those four years, and than claiming and bringing into income the full $200 million in 1993; or

(b) Claiming $200 million on 31 March 1988, all of which would be offset against the charges made againaf income for provisioning for doubtful debts, thus increasing the Bank's income by $200 million in that year, and spreading the premium and foregone interest coat over the next five accounting periods.

Of these two extremes the latter is the more objectionable in that it has the effect of anticipating income contrary to the criterion of -prudence- stipulated in paragraph 4.8 of SSAP-1.

The reality of the Bank's use of the arrangements fell between these extremes.

Legal nature of arrangements

24.17 The formal legal documents evidencing the arrangements describe the arrangements in terms of insurance and reinsurance. We have examined the question of whether the arrangements were insurance contracts as a manor of law.

24.18 We are of the view that when regard is had to all of the surrounding documents and circumstances it is doubtful whether the arrangements can properly be described at law as a contract of insurance. We do not consider that the formal documents evidenced the complete agreement between the parties and the memoranda presented to the respective boards of the Bank and EPBC and the surrounding circumstances must be looked at to determine the true nature of the arrangements. In addition, there was no sufficient element of speculation or risk as far as the insurer was concerned for the arrangements to be a true contract of insurance. The question is not beyond doubt because of the width of the pronouncements in a recent decision at appellate level of the Australian Federal Court. We have doubts as to the proper basis of that decision but if its authority is accepted there may be grounds for treating the present arrangements as being a true contract of insurance. We are of no doubt, however, that for accounting purposes, and when examined from an economic perspective, the arrangements were not in substance an insurance policy but a form of investment.

Uee of the arrenqemenfe at 31 March 1988_

24.19 **The arrangements were put in place on 30 March 1988. The Board was informed by management that there were "obvious benefits- to the Bank in entering into the transaction and effecting the payment of the premium before 31 March 1988. We have been unable to find what those "obvious benefits" were.**

24.20 **We have been told that there was the possibility of a taxation benefit to the Bank through the expensing, for tax purposes, in the financial year ended 31 March 1988, of some or** all **of the premium which the Bank paid on 30 March 1988. No such benefit accrued to the Bank and we are confident that if the Bank had sought proper taxation advice at the time it would have appreciated that any such benefit was impossible to obtain under tax law of the time.**

24.21 **We were concerned to see whether the "obvious benefits" related to the ability of the Bank to offset some or** all **of the $200 million claimable under the arrangements against the charge made against income for provisioning for bad and doubtful debt provisioning in the Bank's financial statements for the year ended 31 March 1988.**

24.22 **We examined this question closely. We reviewed the relevant material considered by the Board of the Bank from September 1987 onwards. We reviewed the working papers of the Bank's auditors, E & Y. We questioned the Bank's then directors and executives at length. We have found no evidence to indicate that the Bank's financial statements for the year ended 31 March 1988 were amended or adjusted in any way on account of the Bank's ability to make claims of up to $200 million against the arrangements.**

Limited use of the arrangements in financial statements in 1988-1989

!4.23 We found that the Bank first recognised income as a benefit under the arrangements in its interim financial statements for the six months ended 30 September 1988. Bank management proposed that the Bank make a claim of $60 million to be offset against the charge for provision for doubtful debts in that period. After extensive discussion the Board decided to take only $20 million of benefits under the arrangements. This amount approximately represented the amount of the premium under the arrangements expensed to that point ($11 million) and the amount of the interest foregone on the Bank's investment in the insurance premium ($7 million).

24.24 Our findings are that the Directors of the time were of the view that it was unacceptable to claim more than the cost of premium amortised to date and the interest income foregone to the same point because that would have meant anticipating unearned income.

24.25 We are satisfied that the Board of the Bank adopted an accounting policy from October 1988 not to claim more in benefits than was matched by the costs of the arrangements incurred to the same point. This policy is evidenced in various internal Bank memoranda and documents, and was followed in the Bank's financial statements in the year ended 31 March 1989 (when $40 million of benefits was claimed) and in the interim financial statements for the six months to 30 September 1989.

24.26 The Bank suffered a major loss in the year ended 31 March 1989 ($946 million before tax, $648 million after tax and extraordinaries) which was followed by a capital injection through a rights issue to existing shareholders, underwritten by the Crown, .and the sale of shares to Capital Markets Limited. There were a number of changes to the Board of the Bank during 1989, with Campbell, Pearson, Lojkine, Learning and Morrison all leaving the Board and being

replaced by Sadler, Pasley, Fay, Congreve and Ricketts

More extensive use of the arrangements in 1990

24.27 The Bank made its most extensive use of the arrangements in the year ended 31 March 1990, in which benefits of $94 million were claimed. Of this amount, $54 million was used to reduce the charge made for provisioning on account of doubtful debts while the remainder was used to offset the charge made for amortisation of the premium ($22 million) while the balance ($18 million) was added to interest income to compensate for the foregone interest on the premium.

24.28 The Bank recorded net profit before tax and extraordinaries of $100 million in the year ended 31 March 1990. At first sight the Bank's use of the arrangement appeared to contribute over half ($55 million) of that pre-tax profit. That influence was not disclosed in the Bank's financial statements. The financial statements had an unqualified audit report from the Bank's auditors, E & Y.

24.29 The Bank's use of the arrangements gave rise to a number of important questions, including:

(a) How should an arrangement like that entered into by the Bank in March 1988 be accounted for in the financial statements of the Bank?

-(b) Was it open to the Bank to use the accounting treatment it did for the arrangements in 1990?

(c) Why was the influence on the Bank's profitability not disclosed?

(d) Was it open to E & Y to give the financial statements an unqualified audit opinion?

24.30 We have studied the records of the Bank and of E & Y and have received evidence from past and present directors and executives of the Bank. We have heard from independent expert witnesses called by the Bank (Trow) and by certain 1990 directors (Hays). We have heard from the responsible audit partner in E & Y (Carty) and from E & Y's National Director of Accounting (Hickey). We have received submissions from counsel for the main parties. We have researched accounting literature in New Zealand and abroad. We have reached the following conclusions:

(a) To accord with best accounting practice, supported by relevant accounting authorities from the United States, the appropriate way to treat arrangements of the nature entered into by the Bank is to treat them according to their economic substance rather than their purported legal form. That is, the arrangements should be treated as a deposit earning interest each year rather than as an insurance contract. Our review of accounting literature indicates that the concept of treating manors according to their substance rather than their form was entrenched in accounting thinking well before 1990;

(b) In our view it was not open to the Bank to use the accounting treatment it followed in 1990. That method was:

(i) inconsistent with the Bank's own general accounting policy of matching revenues with expenses;

(ii) inconsistent with the particular accounting policy adopted by the Bank in October 1988 to record benefits taken under the arrangement;

iii) ii) contrary to the views of E & Y that a different form of 'matching' expenses to revenues should be adopted by the Bank;

iv) v) responsible for the anticipation of income which was neither
prudent nor conservative;

(v) without authoritative support and outside the bounds of generally accepted accounting practice at that time.

(c)

The directors' reason for not disclosing the influence in the accounts was that the impact on the Bank's balance sheet level of doubtful debt provisioning ($1.2 billion) was not material. The directors argued moreover that there was no influence on the Bank's profitability because if the Bank had not used the arrangements it would have made a corresponding reduction in its general provision for doubtful debts. We do not accept these arguments. In our view the influence of the arrangements should be measured against the Bank's pre-tax profits and on any measure a $55 million net influence is material. The level of doubtful debt provisioning should not have been open to arbitrary reduction in this way;

(d)

E & Y did not agree with the way in which the Bank accounted for the arrangements. They argued that an approach which E & Y called.matching" required the Bank to offset, against the benefits taken, the same proportion of the total premium paid as the proportion of benefits taken. In other words, if the Bank took $100 million in benefits it would have to expense $55 million of the
premium. The application of this matching approach resulted in an

(e) In our view E & Y's approach to matching was flawed. It allowed the anticipation of income in that it failed to include interest foregone as one of the expenses to be matched. Their assessment of the overstatement of the Bank's profit arising from the use of the arrangements was $28 million less than it should have been.

(f) E & Y then took into account other variances between their views on accounting treatment for various items and the Bank's views (referred to as the wonders and overs" calculations) and came to the view that overall the Bank's profits were not materially overstated.

(g) The Bank's 1990 accounting profit included $32 million resulting from certain gains accruing to the Bank from the Perpetual Subordinated Capital Notes issued in 1989. That amount included gains for 1999 and 1990 and was incorrectly calculated on a straight-line rather than a yield to maturity basis. The outcome of the incorrect treatment for the capital notes was that the Bank's 1990 pre-tax profit was overstated by a further $16 million in addition to the effect of the arrangements.

(h) Overall the Bank's 1990 pre-tax profit of $100 million was overstated by $66 million.

24.31 We received submissions that this overstatement was not material. We reject those submissions as lacking credibility.

24.32 We found from our examination of the Bank's records that the directors of the Bank were told in May 1990 that, if analysts were made aware of:

a) the benefits taken under the arrangements

b) the gain on the Capital Notes;

c) the effects of certain other abnormal items and changes in accounting policy or practice;

they could compute that the Bank would have incurred, (assuming it took no benefits under the arrangements), a significant pretax, pre-extraordinaries loss. We observed that the Chairman and Managing Director of the Bank informed the Minister of Finance prior to the release of the 1990 financial statements that the profit being announced was affected by a number of one-off items, that the Bank expected to have to make significantly increased provisioning against its Australian exposures, and that the Bank needed a significant injection of capital to assist its profitability. There was no suggestion of these concerns in the Bank's Annual Report.

24.33 We find that the Bank's profit and loss account for the year ended 31 March 1990 did not present a true and fair view of the results of the Bank for that year.

24.34 In our view the Bank's accounting in 1990 was an example of `creative accounting", a term which had considerable currency in the late 1980's following the sharemarket crash and revelations about shortcomings in the application of existing accounting standards by companies in New Zealand and elsewhere.

24.35 "Creative accounting" was a practice condemned at the time by the Commission and by many commentators, including Trow. The Committee of Enquiry into the Sharemarket (the Russell Committee) was similarly critical of some companies for enhancing profitability using innovative accounting practices.

Use of the arrangements In year ending 31 March 1991

24.36 Later in 1990 the Bank announced a second major restructuring, with the formation of Adbro Investments Limited, owned by the Crown and Fay Richwhite & Co Limited, to take a significant quantity of the Bank's non-performing and doubtful debts. In the year ended 31 March 1991 the Bank announced an after-tax after-extraordinaries loss of $71 million. This followed significantly increased provisioning in respect of the Bank's Australian exposures.

24.37 The Bank took a further $38 million of benefits under the arrangements which almost neutralised the cost of the arrangements for the period.

24.38 In November 1990 the Bank announced the establishment of an Operational Review Committee chaired by Fay and including Pyne and Sedler. This Committee was established at the request of the Minister of Finance and reported back to her. It commissioned Coopers to undertake a review of the Bank's major accounting policies.

24.39 **Coopers and Lybrand advised the Bank that the arrangements should have been accounted for as an investment on a YTM basis in accordance with their substance. However they advised the Bank that the making of an accounting policy change to achieve this "may raise public concerns as to the motives behind such a change.. Coopers said that before making any accounting policy change the Board should consider whether the making (and therefore disclosing) of such a change would `improve the overall credibility of the [Bank's] financial statements". The directors of the Bank were advised that the making of such a change would not only have lowered shareholders' funds as at 31 March** 1990 but **also resulted in the Bank reporting increased profitability for 1992 and 1993.**

24.40 The over-statement in shareholders' funds as at 31 March 1991 was not in our view material. However the making of the accounting policy change in the financial statements to 31 March 1991 would have removed a foreseeable, possibly material, distorting effect on the Bank's profitability in the next two financial years. (The influence of any accounting policy change on future years' results is an important consideration in any decision to make such a change.)

24.41 By 1991 E & Y also considered that the Bank should be reporting the arrangements on a YTM basis.

24.42 The Bank decided to continue with its 1990 style treatment. We consider the 1991 treatment adopted by the Board was inappropriate. We believe that, once advised that another approach was preferable, the Bank should have made an accounting policy change at that time.

uee of the erranqemente In 1992 and 1993_

24.43 In the year ended 31 March 1992 the Bank took only $6 million in benefits under the arrangements. This resulted in a non-recurring under-statement of $36 million in the Bank's reported profitability. Again this was not disclosed and was not commented on by E & Y.

24.44 Having reviewed E & Y's _unders and overs. schedule, and having adjusted this for a continued overstatement of profit arising from the Capital Notes, we concluded that the Bank's pre-tax profit for the year was understated by around $23 million. We accept the submission made to us that this level of understatement was not sufficiently material for us to find that the Bank's 1992 financial statements did not present a true and fair view of the Bank's results or **state of affairs for the year.**

24.46 The Crown and FRL announced the sale of their shares in the Bank to the National Australia Bank group in July 1992. NAB made an offer to minority shareholders on similar terms. The Bank's independent directors retained Borings to report on the fairness of the offer. They were specifically asked to indicate if there was any information which NAB had which might effect the views of the minority shareholders if it was known to them. Barings said there was not. From submissions made to us by Barings it would seem they did not fully appreciate the impact of the arrangements on the Bank's future core profitability but this did not affect their own calculations of the Bank's worth which was done on a discounted cash flow basis. As with the Bank's 1992 financial statements we do not find the influence of the arrangements on the Bank's profit as disclosed in the offer document (being the 1992 accounts) to be sufficiently material to require disclosure to the minority shareholders in the takeover.

24.46 The arrangements terminated on 31 March 1993 when the Bank received $170 million from DKB in settlement of its final claim under the arrangements.

24.47 We anticipate that the Bank's reported pre-tax profits for 1993 will be understated by $20 million as a result of the arrangements.

8onk'e debt proopectuoee

24.48 Throughout the period of the arrangements the Bank was an issuer of debt securities in terms of the Securities Act 1978, issuing a prospectus each six months commencing from July 1988.

24.49 The influence of the arrangements on the Bank's profitability was not disclosed or referred to in any way in any of the Bank's debt security prospectuses except Debt Security Prospectus No 8 issued in December 1990. That prospectus included an extensive description of the Adbro restructuring and incorporated an adjustment of some $60 million in the opening level of the Bank's specific provisioning for

doubtful debts.

24.50 This discrepancy was found by the Registrar's staff and the evidence is that the Bank's staff went to considerable lengths, in consultation with the Bank's legal advisers and auditors, to devise a form of descriptive wording which avoided the need to disclose the existence of the arrangements. It was a souled and consistent policy of the Bank not to disclose the existence of the arrangements.

24.51 In our view this description, while not adequate, was not a significant enough item in the context of the prospectus to materially effect the view an investor would form of the performance of the Bank.

The CommIselon's main concerns

24.52 There are a number of findings arising from our enquiry which have given us cause for concern. We summarise these as follows:

(a) The information provided to the Board by management in support of **the recommendation for approval of the arrangements was inadequate;**

(b) The Bank misstated its profit position as at 31 March 1990 by anticipating income to be earned in later periods;

(c) **The** Bank published financial statements in 1990 which did not give a true and fair view of the results of the Bank for the year ending 31 **March 1990;**

(d) The Bank's auditors provided the Bank with an unqualified audit report in relation to the financial year ending 31 March 1990 in circumstances in which we consider it was not appropriate:

(e) **The Bank did not make a change in accounting policy recommended in 1991 which would have prevented foreseeable future distortions In the Bank's profit and corrected the over-statement in shareholders' funds which was then apparent. The distorting effect on the Bank's future profits had the potential to be material although the over-statement in shareholders' funds was not, in our view, material;**

(f) `. The Bank's use of the arrangements in its financial statements in 1990 was .creative accounting- of a type that attracted adverse comment in the 19908.

Allegetlone mode by Mr W.R. Petere M.P._

24.53 The Commission's enquiry was initiated following certain allegations made in the House of Representatives by Mr W.R. Peters in September 1992 concerning the Bank, its directors, its legal advisers, its auditors, and Fay Richwhite & Co Limited.

24.54 We do not find Mr Peters_ allegations proven in the terms in which they were made. Specifically:

(a) we have found no evidence of fraud or conspiracy;

(b) we have found no evidence that the Bank's March 1999 financial statements were "falsified" by the failure to disclose $200 million of bad or doubtful debts allegedly offset against benefits under the arrangements.

Othe~ImDo~_____matters

?4.55 Furthermore, during the course of our enquiry:

a) **we have found no evidence of improper conduct on the part of the Bank's solicitors, Buddle Findlay or on the part of the Bank's auditors, Ernst & Young (formerly Ernst & Whinney) or BOO Hogg Young Cathie;**

b) **we have found no evidence of breach of fiduciary duty by any director of the Bank;**

(c) **we have found no evidence of any improper influence on tbs activities of the Bank from either of its substantial security holders the Crown and Fay Richwhite & Co Limited.**

25.0 REFERRALS TO OTHER BODIES_

Reglatrar of Companlea_

25.1 **We refer this report to the Registrar of Companies for his consideration. We do not consider that the manors to which we have referred in this Report require any action on the part of the Registrar under the penal provisions of the Companies Act or the Securities Act. Although in the course of this Report we have been critical of the conduct of the Bank's management and of certain of its directors at relevant times we do not consider that penal action would be appropriate or warranted. We think that the Bank and its directors at the relevant times acted on the basis of what they perceived to be an acceptable accounting treatment. The auditors, while not agreeing with the Bank's accounting treatment for the arrangements, gave an unqualified audit report. We do not agree with the**

accounting treatment which was applied. in our view it was inappropriate and not in accordance with best accounting practice. There were errors of judgment on the part of those responsible. However these took place in the context of a complex transaction on which there have been conflicting views. We consider that the criticism expressed publicly in this Report is sufficient censure of the lapses from best accounting practices to which we have drawn attention.

New Zealand Soolety of Accountants

25.2 Our report has identified the capacity of the audit process to accommodate quite large differences of view between that of the auditor and that of the statement preparer with respect to individual items, including items which are separately disclosed in the financial statements, these differences being offset against each other without any disclosure of their existence. Of particular concern was the situation in 1990 and 1991. The unders and overs schedules are discussed in the relevant paragraphs Of this Report.

25.3 We invite the Society to review the relevant auditing standards or technical guidance notes with a view to ensuring that proper guidance is given to audit practitioners over haw tO deal with material differences Of view on individual items as between the directors and the auditors. For instance, it may be desirable, where variances between the auditor and the client are material, that there should be a requirement far the responsible audit partner tO seek an extended review Of the variances by a second partner.

Reserve Bank of New Zealand

25.4 BNZ is a registered Bank subject to the prudential supervision of the Reserve Bank of New Zealand. It was a registered bank throughout the period of the arrangements.

25.5 In our report we identify various problems with the Bank's internal administration, with its published financial statements, and with its debt security prospectuses.

25.6 We refer our report to the Governor of the Reserve Bank of New Zealand and invite him to review the matters discussed and disclosed in our report and to consider whether they are material to the procedures employed in the supervision of registered banks in New Zealand.

Ju8tIce Department_

25.7 The provisions of the Financial Reporting Bill, with their requirement that reporting entities follow "applicable approved accounting standards" as approved by the Financial Reporting Standards Board, are expected to diminish the capacity for companies to engage in 'creative accounting. of the kind outlined in our Report, and to provide additional support to auditors through the required compliance with generally accepted accounting practice.

25.6 The facts uncovered in this Report highlight the advantages of the procedure which exists in England, where the public issuer is required to revise financial statements which do not give a true and fair view, with discretion to require.the directors of the reporting entity concerned to pay the costs of revision where that is appropriate. We doubt that the penal sanctions set out in the Financial Reporting Bill will be as effective in dealing with defective financial statements. We do not think that the sanction of public censure will be appropriate or sufficient in all cases. The Commission's Report on Capital Structure and_

Financial Reporting in New Zealand, December 1989 advocated a procedure of this kind. We refer our report to the Secretary for Justice for him to consider whether a procedure of this kind should be introduced into the Financial Reporting Bill, and whether he should advise the Minister of Justice accordingly.

Chairman

24 May 1993
Securities Commission,
Level 6, Greenock House
139 The Terrace,
P.O. Box 1179,
WELLINGTON

Footnotes

"Captive Insurance Companies, Establishment Operation and Management" by P.A. Bawcutt, published by Woodhead-Faulkner, Cambridge, United Kingdom.

Accounting for Non-Life Financial Reinsurance: A Discussion Paper. Issued in December 1991 by the Institute of Chartered Accountants of England and Wales

Capital Structure and Financial Reporting in New Zealand Report of the Securities Commission. Published by the