Valuation of Assets: Commentary

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INTRODUCTION

A topic dealing with or related to the valuation of assets keeps recurring at conferences of all associations and industry groups such as AMPLA and over the last ten years or so with increasing regularity. It is not just because we are in an increasingly sophisticated age in which science and technology enable us to be more accurate in our assessment of the value of the components of any business. It is not because investors are by and large any more sophisticated in their understanding of what is being offered to them. Generally, as was the case 20 years or more ago, investors will still rely on the advice given to them by directors, independent advisers or experts. What has changed is the increased complexity of business and the large fluctuations in the value of assets during the 1980s and early 1990s requiring higher levels of dependence upon the advice of experts to enable an investor to make an appropriate investment decision.

There is concern about the ability of investors with no particular experience in a specific area of business to understand the intrinsic value of highly speculative and risky projects such as some mining and petroleum projects and an assumption has been made that increased regulation will solve the investment decision making problems associated with risky ventures or more complicated transactions. Consequently, more is now being expected of valuers and experts.

In respect of any industry, it can hardly be said that the valuation of an asset is a science.

In 1987 the *Wall Street Journal* reported about concern in the real estate industry in the United States in the following terms:

> "People crack a lot of jokes about real estate appraisers and their qualification. At a bar in Washington where thrift executives recently gathered, for example, talk turned to the skills appraisers

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> need. In response one of the thrift executives leaned over to a colleague, put two fingers on the man's wrist and felt for a pulse."

English judges have never been slow to comment on the difficulties in their tasks and Danckwerts J was no exception. In *Holt's* case,[1] many years ago, he said:

> "The result is that I must enter into a dim world peopled by the indeterminate spirits of facilitators or unborn souls. It is necessary to assume the prophetic vision of a prospective purchaser at the moment of death of the deceased and firmly reflect the wisdom which might be provided by the knowledge of subsequent events."

and then went on to describe his approach to valuation as "making the most intelligent guess I can".

It seems to me that nothing much has changed.

Part of the increasing difficulty arises as a consequence of the difference between concepts of "price" or "market value" and the "value" of an asset in a particular set of circumstances, usually not involving a sale. We are increasingly concerned with the need to obtain statutory valuations whether in regard to prospectuses, takeovers, accounting obligations or other statutory obligations. In these regulatory valuation requirements, the buyer and seller are often fictitious and exist in circumstances where they do not meet or bargain for a price and where the fictitious seller is not required to sell in the context of all the advice heaped upon her or him. The vast bulk of this law relates to valuations performed for the purpose of fixing value for taxation and other revenue purposes, not for sale and purchase. Accordingly, we need to be clear in our understanding of what we are really talking about in a particular valuation context.

In an effort to make things easier and safer for investors, we also have this seemingly unstoppable urge to protect them by increasing the level of regulation.

In this commentary, I wish to discuss certain aspects of the Exposure Draft of the Australasian Institute of Mining and Metallurgy for the Code and Guidelines for Assessment and Valuation of Mineral Assets and Mineral Securities for Independent Expert Reports, to comment briefly on the distinction between price and value, both topics dealt with by Roger Massy-Greene, and on the valuation pressures increasingly imposed upon the directors of resource companies by s 294 of the Corporations Law and AASB1010 of the Accounting Standards.

DRAFT-CODE AND GUIDELINES FOR ASSESSMENT AND VALUATION FOR MINERAL ASSETS AND MINERAL SECURITIES FOR INDEPENDENT EXPERTS (THE "CODE")

Let me say at the outset that the strengthening of professional skills and standards must be supported as it is important for us as Australians, as in

1. *Holt v Inland Revenue Commissioners* [1953] 2 All ER 1499.

other areas of business, to be able to hold our heads up strongly in the international business community. All efforts made by professional bodies such as the Australian Institute of Mining and Metallurgy to address that challenge are to be encouraged. The issue I take up with the Institute is the way in which it has attempted to tackle the quality of expert valuation reports.

We are all aware of the reasons why there have been developments in this area since the early 1980s resulting in the National Companies and Securities Commission Policy Statement 149 and the steps now being taken to upgrade that Policy Statement and provide for its enforcement. No one could seriously take issue with the need to ensure that investors, boards of directors and management of companies or others who have to rely on independent expert valuation reports are properly informed and there are plenty of examples in the 1980s where that standard was not met.

I doubt that the Code will achieve that objective and think it likely that it will cause more problems for both the independent experts and those it seeks to protect than the existing Policy Statement. I know that other organisations are looking in detail and commenting on the Code and I do not intend to do that in this commentary. However, a number of significant issues concerning it should be raised.

The Code is another example of the national tendency for increased regulation and for those concerned with protecting or increasing standards both in Australia and elsewhere to resort to increased regulation. The Code assumes that a duly qualified, experienced, independent expert or valuer needs to have set out in great detail what he or she must do to complete the valuation report, what assistance he or she needs to be able to call on and how the report should be set out. It overlooks the skills and reputation and the need for professional survival of the independent expert and I suspect if implemented, it is likely to lead to a lowering of standards rather than improving them because of the more checklist-orientated approach required.

I think it also overlooks the major difficulties which arose during the 1980s in the areas of independence and comprehensibility.

The problem of independence is well illustrated by the *Pivot* case.[2] The facts of that case reflected the practice which had developed of asking experts to concur with a conclusion as to value already reached by a company's management or its board and indicated the difficulties which can be encountered if there is a lack of independence. The need to resist coercion and keep truly independent is assumed by investors relying on an independent expert's report. Experts need appropriate encouragement to ensure they do remain truly independent, something which is not and probably could not be dealt with effectively in the Code, although I acknowledge that the Code does set out some rather obvious independence guidelines.

One of the greatest challenges professional organisations in this country face is how to enable the users of professional services to have

2. *Phosphate Co-operative of Australia Ltd v Shears* [1989] VR 665.

an appropriate understanding of the information they are given. That certainly applies to the legal profession (I recently read a document in which there were two different definitions of "ordinary shares" where the same words were used in two different contexts!). It also applies to the accounting profession and in particular in the audit/annual accounts area. I am on a number of boards and sit on an audit committee and, in my experience, the average investor would find much of the information given in annual accounts incomprehensible without further explanation and lacking in relevance from an investment decision point of view given its historical nature. This is not however the place to pursue that topic.

The same comment applies to much of what would be included in a valuation report prepared in accordance with the Code.

It is interesting to compare the aims of Policy Statement 149 and the Code. Both set out to establish some principles and matters to be taken into account by the expert and needed by an investor. Without taking issue with those assumptions, Policy Statement 149 stated that it was an aim to present such information "in a clear and helpful manner that is useful and easily readable by investors". Although the Code does require a report to be written in plain English for informed "laymen" (whoever they might be) it does not reiterate that aim which seems strange and supports criticism that it might be somewhat user-unfriendly!

The definition of "expert" in the Corporations Law seems to make sense:

> "Expert, in relation to a matter, means a person whose profession or reputation gives authority to a statement made by him or her in relation to that matter."

Perhaps it might just be better to reinforce that definition in setting out what are the general expectation levels of expert reports. There is some precedent for that approach in the adoption of the use of so called "fuzzy law" in the prospectus provisions of the Corporations Law (s 1022).

Another major concern with the Code is, as I have said, that it can be interpreted as being, in effect, a due diligence checklist of matters that must be dealt with in an expert's report. An expert's report from an investor's viewpoint has nothing to do with due diligence as it is a view on the value of an asset or whether or not a transaction is fair and reasonable given certain information provided and certain assumptions made. The due diligence defence for an expert under s 1009 of the Corporations Law is noted but that is a different issue.

The expert must be able to rely on the information provided by those in positions of authority to provide it in order to assist with efficiency in preparing the report in a cost-effective manner and should not feel the need to continually look over her or his shoulder for hidden dangers.

Further, there is a philosophical difficulty between the approach reflected in s 1022 of the Corporations Law and the checklist approach, the former being, in my view, preferable. Having said that, the Code has a bet each way because in cl 191 it imposes on the expert a similar obligation to that contained in s 1022.

Apart from the conceptual danger of it being seen as a due diligence checklist, there is a legal risk to the expert if he or she does not follow the requirements of the Code to the letter. It is not too difficult to envisage a set of circumstances in which something goes horribly wrong resulting in lawyers anxiously comparing the valuation report with the requirements of the Code and, if necessary through discovery, the experts' whole file to ascertain whether every paragraph set out in it has been complied with. Failure to do so opens up all sorts of opportunities in the professional indemnity-negligence field in which all professionals are now increasingly at risk.

The potential costs associated with an expert having on each occasion to work through the Code requirements is also a matter of concern. Competitive cost pressures are increasingly being felt by all professional service organisations and those pressures are likely to continue for the rest of this century. Obviously an expert's valuation or report must bear an appropriate cost given what is needed to prepare it properly. That should be a matter of judgment on the part of the expert and negotiation between the expert and the person or company commissioning the report. It is likely that the need to comply with the letter of the Code will increase the cost of preparing such a report thereby increasing the commercial pressures placed on the expert in handling the sensitive issue of cost and tempting him for economic reasons to cut corners. It is doubtful that the increased cost will add a compensatory level of quality to the report.

One example of that is in the application of the Code to the issue of "materiality" which is stated to be an overriding consideration in the application of the Code.

The concept of materiality and how to define it has always been difficult. In this context, the accounting profession's rule of thumb of greater than 10 per cent variance is material is not something that can be automatically applied. It really is a matter of judgment for the expert. However, under the Code, the expert is left with the following and, I think, rather unhelpful set of instructions:

- "The reviewing and reporting requirements of this Code can only be departed from wherever the departures would not materially impact on the expert's assessment or valuation."
- "In view of the large number of factors which may materially impact on the conclusions of a Report, experts will normally need to review a wide range of information including published reports, previous independent or similar reports, and internal reports."
- "The cost of the report will normally reflect the value of the mineral assets or mineral securities involved."
- "Emphasis is to be placed on maximum rather than minimum disclosure . . . and that there are no material omissions."

In all the circumstances an expert would be excused for conservatively moving to an information overload approach in complying with the materiality obligations imposed, regardless of cost.

Neil Cole presented a commentary[3] on a similar topic at the AMPLA conference in 1990 and whilst his comments related to Release 149, I take the liberty of quoting from the conclusion to his paper, the thrust of which I agree with and support.

> "If you have formed a view from these comments as to the possibly unreasonable depth, complexity, time and cost that now forms part of independent expert reporting, I would have to agree with your view.
>
> Can there be a simpler approach? In noting the relevant judgments concerning independent reports and the comments concerning those judgments made in the other papers on this topic, I have to believe there is a simpler approach available.
>
> I believe the professional advisory community, interacting with the corporate community, should examine and possibly promote an approach to reporting which has as its cornerstone the obligation to report, not in conformity with the demands of the 89 separate paragraphs of Release 149 and the seven other interrelated NCSC Releases, but at least in keeping with contemporary professional standards as they exist in practice from time to time.
>
> Such reporting standards, and the liabilities arising from short cuts or any other non-conformity, would rest on the shoulders of the reporting authors. Peer group pressure and an occasionally critical comment from the NCSC, the ASC or Corporate Affairs through the requisitions process and otherwise should be able to provide regulation with less red tape. My belief is that the onus should be left to rest with the experts to report on all things likely to be material, in the view of such experts.
>
> Some successful examples of the adequacy of the materiality test for expert reports can be found with reports prepared for presentation to the different States' Commissioners for Stamp Duties. If the case presented is not sufficiently well argued as to material detail, the report is not accepted, and the Commissioner concerned proceeds to levy stamp duty on a frequently discretionary basis of his choosing.
>
> I believe the current modus operandi for expert reports is too complex, too time-consuming, too demanding and does not recognise the clash of interests that relate to the differences of focus and priorities for prospectus, s 12(g), s 23 and s 319 reports. The most important reason for considering change to the mandatory procedures may be that the present system is probably not going to catch out many wrongdoers."

SECTION 294(4) AND AASB1010

Much discussion and debate has occurred around boardroom tables and within the audit committees of many Australian companies during the

3. Neil H Coles, "Comment on the Independent Expert Valuation of Resources Properties: Regulation and Practice" [1990] *AMPLA Yearbook* 216.

last two years or so about the application of s 294(4) of the Corporations Law and Accounting Standard AASB1010 to the value of non-current assets. Section 294(4) has been with us for many years whilst AASB1010 is a revision of an existing standard. They have become particularly relevant at this time due to the impact of the recession on the value of some assets and commodity prices. Ascertaining the value of assets such as exploration assets has not been an easy task in this environment.

AASB1010 provides that where the carrying amount of a non-current asset is greater than its recoverable amount, the non-current asset must be revalued down to its recoverable amount. Recoverable amount is defined as being "the net amount that is expected to be recovered through the cash inflows and outflows arising from its continued and subsequent disposal". That has often been described as the assets value to the company as a going concern although there must be some doubt as to whether that is really a "value" in the general sense.

AASB1010 does not require the net cash flows to be discounted and critics of the standard would argue that is a major deficiency in it. Wayne Lonergan[4] argues that commercial common sense dictates that "recoverable amount" should be calculated on a present value basis rather than on a gross basis and I must say that view appears reasonable if a balance sheet is to have some real meaning as at a particular balance date. However that is not presently the case.

Section 294(4) of the Corporations Law states that company directors have an obligation to take reasonable steps "to find out whether the value of any non-current asset is shown in the company's accounting records at an amount that, having regard to the asset's value to the company as a going concern, exceeds the amount that it would have been reasonable for the company to spend to acquire the assets at the end of the financial year", that is to require directors to consider and compare the carrying amount of the asset with:

(i) the value of the asset to the company as a going concern, arguably its recoverable amount subject to the discounting argument I have previously referred to. It would be convenient to say that this is the same test as in AASB1010 and given the legal enforceability of such accounting standards, it is generally assumed it is. It would be rather unrealistic to argue to the contrary given the desirability of not finding a conflict if possible under the rules of statutory interpretation and that both s 294(4) and AASB1010 stand side by side; and

(ii) the amount that it would have been reasonable for the company to spend to acquire the asset as at the end of that financial year. This is not necessarily its current market value as there may be other amounts associated with the replacement of the asset which would enable a greater amount to be spent and it must be read in the context of the company as a going concern.

Whilst at first glance the valuation tests may appear to be in conflict and there has been some concern expressed along those lines, the better

4. Wayne Lonergan, "Let's get serious" (1992) (March) *Charter*.

view would appear to be that they are not, whilst also recognising that they are also not the same test. The reasonable amount required to be determined by s 294(4) is to be compared to its recoverable amount (that is, its present value to the company as a going concern) and then to its current book value to see if its value needs to be adjusted or dealt with by way of note under s 294(4).

It does not appear logical to argue that the obligation involves a two step process of first adjusting the value shown in the accounting records to match the value to the company as a going concern and then comparing that value to the amount that would have been reasonable for the company to spend to buy the asset as was originally suggested by the Australian Securities Commission in Practice Note 21 (paras 5, 6 and 10).

However, in April of this year, the Australian Securities Commission amended Practice Note 21 in an attempt to clarify the matter. The amended Practice Note appears, at first glance, to overcome the difficulty of the two different tests by stating that where an asset has been written down to recoverable amount in accordance with the requirements of AASB1010, such a write-down would be considered adequate provisioning for writing down the value of that asset in accordance with s 294(4).

The amended Practice Note is pragmatic in its approach but it does not have the force of law and whilst it does, in practice, protect directors of companies from challenge by the Australian Securities Commission if they follow the ruling, it does not protect the directors from actions or legal challenge by others, for example, disgruntled shareholders who can legitimately argue that the failure to look to the second part of the test in s 294(4) has caused them loss. The two tests may not be in conflict but they are not identical. We have all experienced the difficulty in the taxation area of law by administrative action and that is not good enough.

The matter needs legislative clarification. Consideration needs to be given to the discount issue and for two similar obligations to be imposed upon directors—why not legally consolidate them into one?

What is the particular relevance of all that to the subject matter of this commentary? Section 294(4) requires the directors to take "reasonable steps" in regard to the valuation obligation imposed upon them. Further AASB1010 in para 19 requires the accounts of a company or group to disclose, inter alia, the basis of any revaluation made and whether the revalued carrying amounts have been determined in accordance with an independent valuation made by an independent expert.

Circumstances will undoubtedly arise where directors are not content to rely on their own valuation but will require assistance from an independent expert who has particular knowledge and skills to ensure they have taken such reasonable steps and hence the relevance of NCSC Release 149 and the Exposure Draft Code.

Failure to properly deal with the valuation obligation can have dire consequences to directors as Mr Eise, the Chairman of the National Safety

Council Victoria, recently discovered[5] (the *Commonwealth Bank of Australia v Eise* and see also *Leeds Estate, Building & Investment Co v Shepherd* and *Re City Equitable Fire Insurance Co Ltd.*

Directors of a company who do not seek such assistance from independent experts expose themselves to considerable risk if something goes amiss. Arguably, such directors may not have taken reasonable steps for the purposes of s 294(4).

Finally, it is worth noting in passing that the materiality requirement attracted by most accounting standards applies to AASB1010 and so directors need to direct their minds to that factor in complying with AASB1010. That however has no application to an interpretation of s 294(4) of the Corporations Law which may in some circumstances become a problem.

In the meantime and particularly given a continuation of our present economic climate with fluctuating prices in the resource industries, I would expect directors will continue to need assistance from their management and in some cases, independent valuation support, to comply with those obligations.

PRICE AND VALUE

The distinction between price and value is an important one and one which must be understood in the context in which experts are required to give valuations. The asking price of an asset may not be its real value to the buyer. The price offered for a share and on which an expert is required to opine as being fair and reasonable in a takeover may not, on any number of valuation tests, represent its value although arguably it might at that date reflect its market price, for example the difference between controlling interests and small parcels of shares.

The value of an asset could be its book value, its liquidation value, its historical cost value, its going concern value, its market value, its sale value and so on. In each case, the concept of value is influenced by its purpose.

There have been numerous judicial pronouncements of the meaning of the word "value" and one which highlights the distinction between price and value is the following by Griffith CJ[6] in *Spencer v Commonwealth*:

> "In my judgment the test of value of land is to be determined, not by enquiring what price a man desiring to sell could actually have obtained for it on a given day, that is whether there was in fact on that day a willing buyer, but by enquiring 'what would a man desiring to buy the land have had to pay for it on that day to a vendor willing to sell it for a fair price but not desirous to sell.' "

5. *Commonwealth Bank of Australia v Eise* (1991) 6 ACSR 1; *Leeds Estate Building & Investment Co v Shepherd* (1887) 36 Ch D 787; *Re City Equitable Fire Insurance Co Ltd* [1925] Ch 407.
6. *Spencer v Commonwealth* (1907) 5 CLR 418.

In the present context, we need to carefully analyse what the expert is being asked to opine on, that is, is it price and its fairness or reasonableness or is it its value in a non-price related context, for example for the purpose of AASB1010 or s 294(4) of the Corporations Law?

That sounds too easy and, of course, it is not; and as the accounting standards continue to change the philosophical basis for dealing with investor-related information gathering and the trend develops to move away from historical cost and towards market value,[7] the distinction will become more blurred. Perhaps we should not find that so strange in our increasingly complex society.

Human nature must also not be ignored. As Tim Lebbon of Leadenhall Australia Ltd said in a valuation paper delivered in 1991:[8]

> "The question of a business' worth will depend on obtaining the answers to questions such as:
>
> - to whom?
> - for what purpose?
> - with present management as a going concern?
> - on past results or future projectives?
> - how will it be financed?
>
> Value, like beauty, is in the eyes of the beholder."

There are many valid reasons why any particular business interest might be perceived as having different values to different parties. Remember the story of one wise old man to another: "What is 2 plus 2?" and the reply was: "Are we buying or selling?"

In mineral exploration it is the job of the explorer to be ahead of the market, not to follow it, and very successful investors in such companies should be the original stakeholders, not those that follow them. Generally, the value of a permit is based upon what it is expected to return from the ground as an investment. Further, the price at which a buyer would aim to purchase is one which is less than its intrinsic value. Ultimately, there will be different perceptions of value and the negotiation process ultimately concludes in a price being agreed which may or may not reflect either party's actual perception of value although it will obviously be within perceived ranges of value. The distinction between price and value is important and needs to be understood by those involved in the valuation process, particularly when expressing opinions on fairness and reasonableness.

7. Tim Lebbon and Michael Churchill, *Business Valuation Digest*, para 7620.
8. T O Lebbon—*Business Valuations* 1991.