



27 April 2005

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Australian Securities & Investments Commission
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Dear Mr Fawcett,

**RESPONSE TO SPECIFIC QUESTIONS RAISED BY ASIC IN THE ASIC POLICY
PROPOSAL "BETTER EXPERTS' REPORT" ISSUED IN FEBRUARY 2005**

A INDEPENDENCE

A1Q1 Do any practical difficulties arise for experts from this conflicts management obligation? Please specify.

Effective conflict management requires significant resources. However, we believe this is a necessary investment if a licensee is to take on independent expert roles.

A5Q1 Should the expert's conflicts management arrangements reflect existing independence requirements where the report is not labelled 'independent'? If not, what arrangements should apply?

Conflict checking procedures should apply to all assignments undertaken by experts irrespective of whether the output of that assignment will be described as "independent". Furthermore, where a report is limited or otherwise not considered independent, the basis for this limitation should be fully disclosed.

A7Q1 In practice, do experts ever decline to act because of other work with the client? In what circumstances?

Yes. Members decline or decide not to pursue a number of potential appointments as expert.

Reasons for such decisions include:

- Provision of strategic tax or other advice on the subject transaction;
- Other relationships involving relevant strategic advice to bidder or target;
- Audit relationships with bidders (we do not believe that these necessarily represent conflicts);
- Secondments of staff to the company in management roles.

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A7Q2 Should we say that as 'good practice' the expert should have an internal policy on what volume or value of other work for the client may compromise its independence?

No. We do not believe that the absolute value of services provided to a company is a good proxy for independence or non-independence. Potential lack of independence arises from the nature of the other services provided rather than the value of services.

Further, on its own, the fact that no services have been provided to a company is not a guarantee that an expert will approach, or be perceived as approaching, an engagement in a wholly objective fashion. Other relationships with the company, its directors or advisers or a lack of independence in mindset can potentially reduce objectivity.

We consider the current arrangements whereby the potential impact of such services is considered in depth prior to engagement and fully disclosed in the report are appropriate.

A8Q1 Is an expert that also acts as auditor independent?

An auditor is required to be independent. The responsibility of auditors in reporting to shareholders (and by implication maintaining independence from management) is clearly not – on its own - inconsistent with independence in the role of expert.

It will always be necessary to understand other non audit services provided to an audit client. While these may not conflict with the audit role they may affect independence in the expert role (for example the provision of tax advice on restructuring proposals).

The fact of being the auditor alone does not compromise the ability to act as an independent expert.

A8Q2 Is there a concern if the expert audits:

(a) a target, because it might be replace if the bid is successful?

We do not believe this will commonly be a concern.

For large firms with a diversified audit and advisory practice, this will not be a concern as no one audit appointment is crucial to the firm. In any case, based on the specialisation of the expert role, the audit partner will rarely be involved in the expert report

A concern might arise if an audit or other services represented a material portion of the revenue base of the expert firm.

This potential concern is not relevant to situations where the expert report is not in response to a bid. For example, reports under s611 or ASX listing rules.



(b) both the bidder and target?

We do not believe such a role would necessarily compromise independence.

However, market practice is that targets do not appoint experts with any links to the bidder (for example an audit role). Accordingly, many members will not seek appointment to prepare reports for the target where they audit the bidder.

A8Q3 Is there a risk that an expert will be constrained from taking a different view on a financial report from that it took as auditor?

Except where a company is in a situation of distress, it is very unlikely that an expert will provide an assessment that directly relates to figures in the financial report. Specifically:

- the standard of value (i.e. fair market value) used in Independent Experts Reports is not always the same as carrying values in the accounts;
- the expert reports on the value of an overall business rather than the value of individual assets;
- the valuation is made at a point in time and hence overall business values at the date of an expert report will not necessarily be the same as values at the date of audited balance sheets.

However, an expert should consider any potential conflict arising from the past or future performance of audit work before accepting appointment.

A9Q1 Should an expert disclose if the financial or legal adviser that referred it to a client has frequently referred it to clients in the past?

We believe that this is a very important issue and that there is some merit in this proposal, although significant practical difficulties emerge.

It acknowledges that relationships between experts and advisers (who may have large contingent fees dependent upon a transaction proceeding or being rejected) are potentially more compromising of independence than relationships with the company commissioning the expert report.

The Board of the company are charged with acting in the best interests of shareholders and it is highly desirable that they not be unduly influenced by advisers in appointing experts. However, if advisers do have significant influence on the engagement of experts, relationships between the adviser and expert are extremely relevant to considering independence.

We believe that the most practical solution to address the independence of the appointment process would be if directors disclosed in the target statement or explanatory memorandum the considerations made in selecting the expert.

In practice, the concept of referral may be too vague to disclose on a consistent basis. However, there may be merit in experts disclosing, in the attachments to their reports, the percentage of their total firm's revenue during the past twelve months derived from expert reports, such that the issue of dependence on ongoing independence business of this type (and associated referrals) will be highlighted for shareholders and directors. Furthermore, guidance could be provided by ASIC regarding factors to be considered when assessing independence with respect to past and ongoing relationships with advisers.



A11Q1 Should we require that there is a separate organisational unit or person (e.g. in the compliance area) that monitors compliance with internal policies?

Yes.

Such segregation in monitoring compliance with policies is fundamental to the efficacy of important internal policies. We note that compliance policies exist under existing AFS licence requirements.

A12Q1 Should the expert ever discuss with the client the substance of the expert's report (apart from factual inquiry), analysis or the methodology used? In what circumstances?

The substance, conclusions and methodology of the report should not be discussed prior to finalisation of the report.

However, some disclosure of methodology will be inherent in the definition of information requirements at the outset of the engagement and information gathering and interviewing of management during preparation of the report. For example, if a focus is to be placed on the DCF approach clearly resources and information requests will target the development of medium term forecasts. We believe that such discussion is appropriate and, in practice, inevitable. However, there should not be discussion of the decision of the expert to apply such methodologies.

In practice, it is also common for the directors to receive a complete final draft (under the process considered at A12Q2) and may request a meeting with the expert to ensure that the directors have a full understanding of the report. Risks that may arise from this practice are adequately dealt with by the provisions of Practice Note 42.

A12Q2 At what stage should the draft report be at the time it is sent to the client?

The confirmation of factual accuracy will be partly determined by timetable. However, our preference is that primarily factual sections (such as company description, industry analysis, historic financial performance and forecast performance) be reviewed by the company for factual accuracy prior to the completion of draft reports.

Ideally complete draft reports should be provided to the company only after the finalisation of the draft (i.e. after all licensee review processes on the report have been completed).

This latter procedure ensures that any changes to the final draft report in the light of company comments are clearly identified and scrutinised by the reviewers of the report and, if appropriate, disclosed in the final report in accordance with paragraph 24 of Practice Note 42.

A12Q3 In practice, do experts give to the client for fact checking:

- (a) that part of the report containing factual discussion only;**
- (b) the whole report, but with conclusions and important figures deleted;
or**
- (c) the whole report?**



Which option is preferable? Give reasons:

If the expert has concerns in relation to factual information extracted from company records or sources, it is desirable that Client checking should occur at stage (a) and stage (b). In most cases, practitioners prefer checking at these stages of a report's preparation.

In some circumstances a report may be sent by practitioners at stage c – perhaps due to time pressure or because factual issues are not anticipated. Providing strong internal procedures apply to the updating of draft reports (as discussed above), we do not believe provision of the whole report for factual checking represents a problem.

A13Q1 Should staff working in corporate finance or advisory supervise those working on expert's reports?

Preparation of experts' reports should be undertaken by staff with specialist skills in valuations. This reflects the specialist nature of such work and the need to ensure that staff receive regular exposure to this work.

The valuation specialists should be supervised by senior valuation specialists. Expert reports should not be supervised by staff whose primary expertise is in the lead advisory (success fee based) area.

A13Q2 Should information barriers between the expert business and other parts of the firm have a role in our policy? Even if the expert had information barriers, it would still have to avoid the conflicts in proposal A7 and disclose its interests.

Such information barriers should exist in all entities undertaking independent expert reports. Such barriers should protect client confidentiality. (For example if the expert firm has provided advisory services to other companies in an industry or audits such companies).

Such barriers will tend to be client or industry specific rather than restricting staff working in the area producing expert reports working in other areas.

A13Q3 Is it practical to apply information barriers between the expert business and e.g. corporate finance or advisory? Would barriers disrupt the structure of an expert's business? Would barriers prevent staff working on experts' reports gaining further experience of transactions?

Any organisation undertaking expert reports should have systems in place to protect the confidentiality of client information.

If staff have already performed extensive work for clients in a particular sector, consideration should be given to whether existing relationships or exposure to confidential information potentially compromises independence in the expert role for other companies in that sector. In such a circumstance, procedures should be in place to protect client confidential information from being communicated to staff working on a report for a company operating in the same sector.

On their own, we do not consider restrictions on staff preparing expert reports performing other work would have any beneficial impact on the confidentiality of client information or independence.



A16Q1 Does s667A allow this process?

Yes. We believe that 667A accommodates this process.

A16Q2 Do any 90% holders currently improve consideration once they have received the expert's report?

Members have experienced instances where this has been the case.

A16Q3 Is there a risk that 90% holders will set consideration below fair value because they can always improve it if the expert's report is adverse?

Yes. We believe there is a risk of this eventuality.

A18Q1 In the exceptional case that the relevant industry or field is very small, is it reasonable that an industry expert must be independent? Does the expert's specialist knowledge outweigh the risk that the expert's opinion will be compromised?

This should be discouraged. If an independent specialist cannot be identified, the expert should prominently disclose that they have been unable to identify a suitable independent specialist.

In such circumstances, it will typically be unacceptable for an industry expert (eg a geologist or mining engineer) to effectively review their own work and bring no additional value to the process.

A19Q1 Should we change this policy? The expert does not necessarily lack independence because it was appointed by the client.

We agree with the withdrawal of this recommendation.

In practice the company will pay the fees of the industry expert. The issue in relation to indemnities by the company for information provided is handled more directly if the contract for engagement of the industry expert is between the company and the industry expert.

In practice, the party contracting with the industry expert is a secondary issue. The key controls on the appointment of the industry expert are:

- The choice of industry expert is made by the expert not the company;
- The engagement of the industry expert makes it clear that the industry experts' work is for the purpose of the expert report and that they are responsible to the expert;
- The expert reviews the procedures and work undertaken by the expert to the extent necessary to confirm that it meets their requirements.

Other comments re Independence

A 14 We strongly agree with the continued prohibition on experts being remunerated on the basis of particular outcomes.



B EXPERT'S ROLE

B2Q1 Is the language 'fair and reasonable' useful in our policy on the expert's role in an acquisition approved by holders: item 7 of s611, PS 74.9(d) and PS 74.20?

In the context of s611, reference to fair and reasonable does not add value, as the test set out in PS 74 is a broad "best interests" consideration.

As discussed below, we believe that there is scope for ASIC to further define the definition of fair and reasonable in the context of takeover transactions.

B2Q2 Is there a distinction in practice between the fair and reasonable test and the best interests test?

There is a distinction between the fair and reasonable test applied to takeover assessments and the best interests test for s611 or Schemes of Arrangement.

In a takeover, the decision faced by the shareholder is typically whether to realise the shares held (possibly taking scrip as consideration). As such focus is on the price offered and whether there is a prospect of achieving greater value in the longer term (fairness) or the short term (reasonableness).

Under the transaction giving rise to a section 611, ASX listing rule or scheme report, the shareholder is anticipated to continue holding shares (possibly in an expanded entity). As such, long term qualitative assessments are often more relevant to the latter type of report than immediate pricing issues.

For these reasons, we consider the best interests test remains relevant to considering transactions under s611, ASX listing rules or Schemes of Arrangement.

B3Q1 Are there other common or substantial focuses for experts in particular types of transactions that we need to note?

The only other substantial focus for experts is the effect of demergers and/or capital reduction on the interests of creditors. Market practice has coalesced around the analysis required and the conclusions put.

B8Q1 Should we omit this policy?

Yes. While we acknowledge that clear guidance to shareholders is desirable, it is the role of the directors to make a recommendation to shareholders.

Clearly the expert report is a major input into that recommendation.

B8Q2 Or should an expert usually make a recommendation and explain if it does not?

No.

Ultimately it is role of the independent directors to make the recommendation to shareholders. If, based on the findings of the expert, the decision is finely balanced the expert should not usurp the position of the independent directors by making a clear statement on acceptance of an offer or proposal.



If greater emphasis is placed on experts making such statements, there is a risk that the role of independent directors will be undermined.

B9Q1 In a scheme of arrangement, should the expert separately consider the interests of each class under the scheme?

Yes.

The interests of different groups voting on the scheme (for example ordinary shareholders and out of the money option holders) may differ significantly. It is possible that a proposal might be attractive to one class, but unattractive to another class. As such, one single opinion may not cover the interests of each class.

B9Q2 Instead in a scheme should the expert balance the interests of different classes? Is this inconsistent with separate class meetings?

We would not support this suggestion.

It is not the role of the expert to “balance” the interests of different classes. A proposal should be designed to accommodate fairly the interests of different classes. If the proposal does not do this, it is appropriate for the expert to report this to different classes.

B10Q1 Must the board have seriously considered another business proposal?

This is a complex issue. Indeed just defining what constitutes “serious consideration” would be difficult.

The expert is considering the interests of the shareholders. If a board has not considered or adequately explored all alternatives to a proposed transaction, it is important that the existence of other possible alternatives be considered by the expert. The expert should not exclude any potential alternatives simply because the board has not considered them.

Balancing this obligation to consider all alternatives, an expert must be careful in giving weight to unconsidered alternatives or potentially speculative alternatives raised by the board (but for which there is no detailed evaluation). The risk is that a transaction is rejected due to raising the prospect of a transaction that cannot ultimately be completed.

Based on the above considerations, we do not consider that clear guidance can be given on the extent that alternative proposals must have been given serious consideration and this should be an area of judgement and disclosure for an expert.

B10Q2 Is it appropriate for the expert to generate an alternative proposal?

The development of proposals clearly falls outside the role of an independent expert. Taking market soundings or approaching other parties in the market would put the expert into a fundamentally different role and compromise independence.



An expert should consider what potential alternative proposals might be made and ascertain in discussions with the directors:

- whether these alternatives have been considered
- what other alternatives have been considered
- what process has been undertaken to address the likely outcomes of such alternatives
- the uncertainties attaching to such outcomes.

If this process does not satisfy the expert that an adequate process has been undertaken to review alternatives, this should be raised with the independent directors and, if the expert remains unsatisfied, disclosed in the report.

B11Q1 Should we say: the current balance of court authorities is that the expert should exclude ‘special value’ from fair value?

Yes. Based on the *Capricorn Diamonds* decisions and general practice, this a clearly established principle.

Other comments re Experts’ Role

From the perspective of preparing expert reports for target statements, we consider that there is scope to give further guidance on the definition of “fair and reasonable” and potentially reconsider the form of language used in expert reports for target statements.

The issue of strategic value arising from control is generally well understood and, in any case, is clearly set out in the *Capricorn Diamonds* judgement. However, there is some possible divergence in practice in relation to value arising from synergies. Specifically:

- Should the valuation of synergies only focus on synergies available to a number of potential acquirers?
- Should the valuation of synergies consider the synergies that will only arise in the context of one specific acquirer?

The definition of fair market value would incorporate the former category of synergy value, however it would normally exclude the latter component.

While it would be useful for a shareholder in a target to understand the approximate level of potential synergies available to one specific bidder, it is potentially misleading to include part of the value of such potential synergies in fair value. If the synergies cannot be achieved by any other party, no other party will pay for them and it is a matter of opinion as to how much a bidder will reasonably pay for them.

To the extent that a valuer incorporates potential synergies into a valuation, they should clearly identify:

- The extent of such synergies assumed;
- The basis upon which those synergies have been estimated;
- Their understanding of likely potential acquirers who might be expected to achieve such synergies (i.e. whether synergies are available only to the intender acquirer or others);
- The assumed sharing of such synergies between the bidder and the target assumed in the valuation of the target.



Further the estimation of synergies in the context of any transaction involves a high degree of approximation where the target's expert has no access to management and full financial information on the bidder (especially where an expert makes estimates of savings in a bidder's business).

Therefore we believe there is scope to confirm the definition of fair value as being established in line with the normal definition of fair market value rather than a transaction with one particular party.

While the strategic value available to only one party is not a component of fair value, it is relevant that shareholders are provided with estimates that might reasonably be made of the value of a particular acquisition to that one party. For example, it is relevant to understand what additional value an acquirer might be anticipated to recognise above fair market value.

One way of doing this would be to remove the presumption that an offer is reasonable if it is fair.

Using such an approach, on occasions, an offer by one strategic buyer might be fair (as no other bidder would logically match the bid), but not reasonable as the extent of synergies is clearly such that the bidder might be anticipated to pay a higher amount.

Potentially such an assessment would give the shareholder receiving the report a much better understanding of the situation than a report with the headline opinion "neither fair nor reasonable".

C QUALITY AND CONTENT

C9Q1 Should the expert analyse the market price of quoted securities over a period of at least the last 6 months: see s667C(2)?

Yes. Six months would generally be seen as a minimum period for analysis of trading.

The relevant period for analysis is difficult to specify and, in disclosing a minimum period, no sense should be given that this is an appropriate period for analysis in all circumstances.

C10Q1 Are there other common methods or securities to which we should refer?

In referring to the discounted cash flow method, additional wording could be added, "incorporating appropriate techniques to adjust for the uncertainties and potential variability of future cash flows".

Such a reference would emphasise that it may be necessary to utilise probabilistic techniques (eg Monte Carlo) or real options approaches to successfully apply such analysis where future outcomes are highly uncertain.

C14Q1 Is there a type of transaction or valuation method where it is inappropriate to separately attribute a value to a control premium e.g. discounted cash flow?

A number of valuation techniques derive values on a controlling basis - for example reference to precedent acquisition transactions as well as discounted cash flow.



However techniques initially based on minority values - for example reviewing past trading in the company's shares and looking at multiples for comparable listed companies - will be adjusted to incorporate an estimate of control premium if this is required by the purpose of the valuation.

The selection of technique will not affect whether the valuation generates a premium for control. This is determined by the purpose of the valuation.

C15Q1 If the value of consideration is at the lower end of a range of fair values, should the expert make a prominent statement to this effect in the 'summary' or 'opinion' section of its report?

The expert should provide comment and prominent disclosure on where the value of the consideration lies in the range of fair values. Such disclosure should not be restricted to circumstances where consideration is at the low end of the range. It would be no less relevant to give prominent disclosure to the fact that the consideration was in the upper part of the valuation range.

C15Q1 Should the expert instead give a single fair value? Could experts come under more pressure from a client in setting this single value?

Valuation is not a precise science. Any requirement to disclose a single point value would give valuations an implication of spurious accuracy.

The use of a valuation range is a key mechanism by which an expert communicates the uncertainties affecting value and the starting point for commentary on the factors affecting the assessment of value.

C16Q1 Is one point in a range a more likely value than any other point? Is a most probable value useful for investors? Does a single point risk being a theoretical value only?

Value may be assessed to be more likely to fall in one part of a range than another. Such a conclusion will be most evident where probabilistic (Monte Carlo) type approaches are adopted in valuations.

It will be useful to discuss the factors affecting the probabilities of different potential valuation outcomes, but we believe that in most circumstances it is unlikely to be appropriate to identify a single value point as being the most probable value.

C16Q2 Is the most probable value usually the mid-point of the range?

Depending on the distribution of the key drivers determining value, the mid-point may not necessarily be the most probable value in a valuation range.

C17Q1 Should we give further guidance on what constitutes a range that is too wide? What range is reasonable and what factors are relevant?

It would be difficult to define a reasonable range in statistical terms.

In some circumstances, value will be highly uncertain and it would be misleading to present a narrow range. Providing the report explains the factors that affect where value will fall in the range, such a report will be useful to users of the report in understanding the issues relevant to their decision.



Some guidance might be given on factors giving rise to wider valuation ranges.
For example:

- Uncertain business proposition (eg R&D or Biotechnology);
- Very high gearing such that small movements in enterprise value have a highly magnified impact on equity values;
- Organisation specific uncertainties (eg court determinations of damages);
- Financial distress to the extent that it may affect the conduct of the business;
- Poor information on the financial position of the company and its prospects.

C21Q1 If we omit this policy, is there a risk that the client will pressure the expert to omit information that the client argues is not material?

In practice, we have not encountered issues in relation to this provision.

If confidential information is not material to the disclosures and conclusions of a report, an expert will generally exercise their judgment and exclude the information rather than seek relief.

We do not envisage that omission of this policy would give rise to successful arguments that material information should be excluded from a report.

C25Q1 Should we require an expert's report in all cases?

In the vast majority of cases, it is appropriate that an independent expert be engaged to report on all material matters.

However, there may be instances in small companies where the independent directors may be adequately qualified and sufficiently familiar with a transaction to make an informed analysis and recommendation for shareholders and that the saving of an expert's fee is of material benefit to shareholders. In practice this is only likely to apply to reports under s611 for small companies.

In practice, we believe directors should be encouraged to engage experts in all circumstances where transactions are material.

Other comments re Quality and Content

No comments.



**The Institute of
Chartered Accountants
in Australia**

D REGULATORY ACTION

Other comments re Regulatory Action

No comments.

Yours sincerely,

Bill Palmer FCA
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