ASIC

Australian Securities & Investments Commission

REPORT 2

Report of investigation: Burns Philp and Co Ltd

December 1998

REPORT OF THE

INVESTIGATION INTO BURNS PHILP & COMPANY LIMITED

AUSTRALIAN SECURITIES AND INVESTMENTS COMMISSION

DECEMBER 1998

Preface

This document comprises the report provided to the Minister by the Australian Securities & Investments Commission (ASIC), pursuant to subsection 18(1) of the Australian Securities Commission Act 1989 (ASC Law). This report incorporates references to materials and records obtained during the investigation and enquiry.

Pursuant to subsection 18(4) of the ASC Law, it is open to the Minister to cause the whole or part of the report to be printed and published.

In the exercise of the discretion provided by subsection 18(4), the Minister has decided that the report, excluding the materials and records obtained during the investigation and enquiry, be printed and published.

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REPORT ON BURNS PHILP & COMPANY LIMITED

This report has been prepared pursuant to section 17 of the ASIC Act, to make public the findings of ASIC's investigation into the $700 million writedown of assets by Burns Philp in September 1997. The report outlines the circumstances that led to the writedown, and ASIC's conclusions in respect of these circumstances. ASIC believes that there is a public interest in publishing its findings, to better explain how such a large writedown occurred, with little warning in a large, well-established public company of good repute, and to draw a number of corporate governance issues arising from these circumstances to the attention of all participants in Australian markets.

1. INTRODUCTION AND BACKGROUND

1.1 On 24 September 1997 Burns Philp & Company Limited (Burns Philp) announced a writedown of its herbs and spice assets from $850m to $150m. Following this announcement ASIC commenced enquiries to establish what matters had led to such a large change in the reported value of the company's assets.

1.2 Burns Philp co-operated with the ASIC enquiry. ASIC requested, and was provided with, the opportunity to interview Mr Mark Burrows (director and chairman of the audit committee), Mr Derek Docherty (former director, and former chair and member of the audit committee), Mr Ian Clack (former managing director), Mr John Cowling (former director and former chief financial officer) and Mr John Chapman (former chief financial officer).

1.3 Using its power to serve notices for the purpose of ensuring compliance with the Corporations Law, ASIC obtained documents from the company, the company's auditors, KPMG, and the company's advisers, Boston Consulting Group (BCG), Baring Brothers Burrows & Company Ltd (Barings) and Schroders Australia Limited (Schroders).

1.4 Following the initial enquiry, ASIC commenced a formal investigation pursuant to its power under section 13 of the ASIC Law and conducted examinations under section 19 of the ASIC Law. Those examined were the company's auditors from KPMG for the 1996 annual accounts, and staff from Barings and Schroders who participated in the review of the company's tradename values for the 1996 accounts. Valuation Research Corporation (VRC), the American-based valuer of the company's tradenames for the 1996 accounts, provided information by letter in response to ASIC queries.

1.5 This report outlines the findings of ASIC's enquiry and investigation. It highlights the particular matters which led to the large asset writedown, and discusses issues in respect of accounting treatments and corporate governance arising from the manner in which the herbs and spices business was conducted by Burns Philp.

1.6 The ASIC enquiry and investigation raised serious issues about the adequacy of the steps taken by the board of Burns Philp to ensure the accuracy of the reported value of the herbs and spices assets, and about the corporate governance practices of the company. However, ASIC has concluded that the commencement of legal proceedings is not justified in all the circumstances. It is intended that this report will, itself, provide guidance to the market about appropriate standards of conduct.

1.7 Parts 2 to 8 outline the events leading up to the writedown and the consequences of the writedown. ASIC's issues of concern are discussed in Part 9, accounting issues are discussed in Part 10, the conclusions appear at Part 11, and Part 12 summarises matters relevant to the market arising from this enquiry and investigation.

2. THE HERBS AND SPICES BUSINESS OF BURNS PHILP

Original strategy

2.1 By the early 1990's Burns Philp had established a successful global yeast strategy. At that time herbs and spices was an industry perceived by Burns Philp as having a number of desirable attributes. Growing interest in ethnic foods, in North America and Europe particularly, meant that herbs and spices were being utilised more. Additionally, increased emphasis on healthy eating meant that spices were used as a salt and fat substitute.

2.2 In his speech at the Burns Philp AGM on 5 November 1997, the chairman, Alan McGregor, outlined the rationale for Burns Philp's herbs and spice strategy as follows:

> "As the company entered the herbs and spice market it was a niche market, fragmented and open to rationalisation opportunities. As a consequence, the opportunities presented were complementary to Burns Philp's proven and successful yeast strategy. Furthermore in many instances, it enabled the company to be a single source supplier to many customers for their food ingredients products."

2.3 According to the information supplied to ASIC, the principal architects of this strategy were Andrew Turnbull (who was chief executive officer from 1984 to 1994, appointed to the Board in 1983 and appointed chairman in 1994), Ian Clack and John Cowling.

2.4 Burns Philp's strategy was to acquire existing herb and spice businesses, principally in North America and Europe. The strategy particularly focused on acquiring successful herbs and spices tradenames. The intention of this long term strategy was to build sufficient size to exploit economies of scale. To pay for these acquisitions, Burns Philp sold assets which were not part of the core businesses of food and hardware. As well, acquisitions were funded by debt. By 1993 Burns Philp had decided to sell the hardware business, to concentrate on the food businesses.

A summary of cash flows taken from annual financial statements shows the impact of these acquisitions on debt, particularly in the years from 1993 to 1995.

	1990	**1991**	**1992**	**1993**	**1994**	**1995**	**1996**	**1997**
Net cashflows from **operations** in $M	*178.2*	*100.3*	*115.4*	*119.5*	*101.1*	*113.9*	*80.1*	*126.5*
Net cashflows from **investing** in $M *Major outflows arise from acquisitions and slotting fees*	*(163.8)*	*196.0*	*(105.5)*	*(451.2)*	*(432.8)*	*(200.3)*	*(75.9)*	*(193.0)*
Net cashflows from **financing** in $M *Major inflows arise from increased debt*	*(66.3)*	*(9.2)*	*(50.4)*	*250.8*	*186.6*	*188.2*	*75.5*	*(27.3)*

Note: All amounts from financial statements used in this report have been extracted from financial statements in the annual report for the relevant year.

2.5 In 1988 Burns Philp acquired Speciality Brands Inc, the owner of the Spice Islands tradename, in North America. Spice Islands was a producer and marketer of gourmet (premium) herbs and spices. The Canadian Blue Ribbon brand was acquired in 1990 as a licence agreement with T J Lipton Company (Unilever). In 1992 the acquisition of another North American spices and seasonings business, Durkee-French, took place.

2.6 In 1993, two European businesses, British Pepper & Spice and Euroma (Netherlands), were acquired. At the time of acquisition British Pepper & Spice had 22% of the UK retail herb and spice industry.

2.7 In March 1994, Burns Philp acquired the German company Ostmann. The highest bid for this company was made by McCormick, Burns Philp’s major North American competitor. However European anti-trust regulators refused McCormick permission to complete the purchase. The way was then clear for Burns Philp to acquire Ostmann. Also in 1994, the Tone’s business in North America was acquired.

2.8 Following these acquisitions, Burns Philp was the second largest herb and spice producer in North America. The LEK Partnership, a US consulting firm, reviewed and endorsed the overall Burns Philp herbs and spices strategy in 1994.

2.9 For each acquisition, Burns Philp raised substantial restructuring and rationalisation provisions. With the creation of each provision a balancing effect arose, being an increase in the value of intangible assets, including tradenames, technological assets and goodwill. This accounting treatment was permissible at the time. Since June 1996, Abstract 8 of the Urgent Issues Group has significantly reduced the ability to treat restructuring costs in this way.

2.10 When restructuring and rationalisation expenditure was subsequently incurred for the herbs and spices businesses, it was written off against the provisions established on acquisition rather than being charged to annual profit. It was only when the provisions were exhausted that restructuring and rationalisation expenses were charged directly against annual profit. In this way, in 1996 and 1997, expenses relating to the herbs and spices businesses became more obvious in the financial statements.

2.11 The herbs and spices industry can be divided into two principal sectors: consumer and industrial. The consumer sector is made up principally of retail sales of herbs and spices direct to consumers through supermarkets and local specialty stores. The industrial sector supplies herbs and spices principally to food manufacturers for use in processing other food products. Most of Burns Philp's acquisitions were in the consumer sector.

2.12 This weighting in the consumer sector was later identified as a deficiency in the herbs and spices strategy. The trend towards a decline in the number of meals cooked in the home meant that consumer sales suffered, whereas demand was still strong in the industrial sector. In his speech to the AGM in November 1997, Alan McGregor commented:

> "During this period the North American and German markets experienced an overall shrinkage largely due to a decrease in "eating at home". This trend affected all participants in this market but especially Burns Philp because its spice business was overweighted to the consumer market."

Consolidation of the herbs and spices businesses

2.13 Following the acquisition of the Tone's business in 1994, Burns Philp undertook a major rationalisation of the North American spice manufacturing facilities, centralising them at Ankeny in Des Moines, Iowa where a major new facility was established. The 1996 Annual Report stated, "The full benefits of this consolidation have not yet been realised because the initial set up and distribution issues are taking longer to complete than we anticipated. The benefits will be evident in the 1997 year." As discussed below, the costs involved in the rationalisation proved to be higher than anticipated.

McCormick and the slotting war

2.14 When Burns Philp started to acquire herbs and spices businesses, McCormick already held significant shares of both the European and North American markets. A particular feature of the North American market at this time was the payment of "slotting fees" to supermarkets to obtain the right to shelf space. In many cases the payment of a slotting fee ensured that supermarkets would not carry competitors' products. Slotting payments were made up-front and were often in respect of a contract made for three or four years. (The expression "slotting" may also be used to describe features of standard terms of trade such as discounts and rebates. In this report "slotting" refers only to up-front contractual payments.)

2.15 After Burns Philp entered these markets (and particularly following the acquisition of Tone's) McCormick and Burns Philp entered a period of aggressive competition which included the payment of substantial slotting fees to increase market share.

2.16 For some acquisitions, slotting contracts were already in place. In the conduct of due diligence for the acquisition of Tone's, Burns Philp was not advised of contracts with some of Tone's largest customers. In this case, Burns Philp was unwittingly locked into slotting contracts and subsequently took legal action against the vendor. On 30 September 1996 the vendor was ordered to pay Burns Philp an amount of $2.25 million in damages.

2.17 The amount of the slotting payment relating to the first year of the contract was charged against profit in that year. The amount relating to subsequent years was capitalised as prepaid slotting fees, and charged against profit in later years. In the Australian accounting regime, expenses may be capitalised and carried forward when there is a reasonable expectation that sufficient revenue will be earned in later years to recover the expenditure. In the case of the herbs and spices businesses there is an issue as to whether sufficient revenue would have been earned during the contract periods to enable payment of the slotting fees. For example, the company stated in its strategic plan for 1996:

"Within the spice category the major issue facing Burns Philp is the lack of profitability of the spice contracts. This will be an area of major focus during the plan period."

Accordingly it may have been more appropriate to expense the total amount of slotting fees immediately.

2.18 The effect of capitalisation is to increase assets and decrease expenses, improving the appearance of both the balance sheet and the profit and loss statement. Burns Philp chose this approach, deferring the majority of the expenses to future years.

2.19 Burns Philp have stated that capitalisation and subsequent amortisation of slotting fees was a requirement of the regulatory reporting regime applicable in the United States of America at the time. However, the notes to the 1996 accounts state that the financial statements were prepared in accordance with Australian accounting requirements. As noted in paragraph 2.17, compliance with Australian accounting requirements would have meant that Burns Philp had a reasonable expectation that all capitalised slotting fees reported in 1996 would be recovered from future revenues.

2.20 As competition between Burns Philp and McCormick increased, so did the amounts of slotting fees paid to supermarkets. Consequently large amounts of slotting fees were capitalised by Burns Philp as assets, to be amortised against profit in later years.

Burns Philp's annual financial statements disclose the following amounts of capitalised slotting fees, net of accumulated amortisation:

Capitalised Slotting Fees	**1992**	**1993**	**1994**	**1995**	**1996**
Current Assets in $M	-	*23.9*	*30.1*	*54.2*	*35.3*
Non-Current Assets in $M	*3.9*	*57.3*	*74.5*	*131.7*	*84.0*
Total Fees in $M	***3.9***	***81.2***	***104.6***	***185.9***	***119.3***

2.21 The managing director's report in the 1996 annual report noted:

"Clearly we underestimated the competitive reaction to our strategy to quickly and significantly increase our presence in the global food ingredients market".

All of the people to whom ASIC spoke during the course of its enquiry have agreed that the failure to fully assess the competitive reaction from McCormick was a significant factor in the difficulties experienced by the Burns Philp herbs and spices business. It is unclear whether Burns Philp or McCormick was the main instigator of the so-called slotting wars. In his address on 5 November 1997 the chairman noted that "the company had to compete or lose its market share". There is a business issue as to whether the company should have continued to compete for as long as it did, and whether it was appropriate to carry forward capitalised slotting fees as assets when the underlying business had difficulty in supporting both the amortisation charges and the recoverability of the remaining capitalised slotting fees in the balance sheet.

2.22 As the amortisation of previously captitalised slotting fees was taking a heavy toll on profit, Burns Philp reduced these payments in 1996 and stood back to watch the response from McCormick. Since that time, the slotting payments of both Burns Philp and McCormick have diminished.

2.23 The practice of paying slotting fees commenced in Germany after Burns Philp entered that market. The Burns Philp company, Ostmann, decided to pay slotting fees to defend its distribution base. Nevertheless Ostmann lost market share to Fuchs, the major German competitor.

2.24 A large proportion of Burns Philp's capitalised slotting fees were subsequently written off against profit, the amounts being $33.9 million in 1996 and $136.4 million in 1997. This was a recognition that these capitalised fees would not be recovered from future herbs and spices revenue. In 1997 this recognition was part of the $700 million writedown of the herbs and spices assets.

3. BACKGROUND TO THE 1996 FINANCIAL STATEMENTS

Meetings of the board and audit committee in San Francisco

3.1 Toward the middle of 1996, board members were becoming concerned about the effectiveness of the long term herbs and spices strategy, particularly in North America.

3.2 The board and audit committee meetings on 25 May 1996 were held in San Francisco. The chief financial officer also attended, and presentations were made by North American management. It was noted that revenue had decreased due to competition from McCormick. The effect on profit was exacerbated by the amortisation of slotting costs, and the ongoing costs of the Ankeny consolidation, including higher staff costs, contracts lost due to impaired performance, and problems with inventory control. Other factors were: sharp increases in the cost of raw materials, particularly pepper; sharp increases in packaging costs, particularly resin; reduced sales due to the decline in home cooking; and the loss of management and staff to competitors.

3.3 Also at this time, and in the light of worse than expected recent performance, KPMG noted the importance of reviewing the carrying values of slotting costs, tradenames and other intangible assets for the 1996 financial statements.

3.4 Following the San Francisco meeting, there was increasing disquiet amongst directors about the scale of the problems in North America. There was also agreement that these concerns should be addressed in the 1996 financial statements. The action taken is discussed below. While the 1996 financial statements provided no specific analysis of the financial exposure of Burns Philp to the herbs and spices business, the managing director did acknowledge the problems in implementing the herbs and spices strategy in the 1996 annual report:

> “we underestimated the impact on our own management resources of achieving this strategic shift and the short term demands of managing a large, worldwide food ingredients business.”

Organisational change

3.5 To address concerns about quality of management, there were changes to about a third of Burns Philp's fifty senior managers. Three of the most senior management appointments were:

- John Chapman, from Caltex, appointed senior vice president finance in late 1995.
- John Cook, from Kellogg's, appointed president of consumer foods in mid-1996. His skills in marketing tradename products were highly regarded.
- Ned Skinner, appointed president of industrial/food service later in 1996.

3.6 Also in 1996, to improve reporting and provide better service to customers, Burns Philp changed from a structure based on regions - North America, South America, Asia-Pacific and Europe - to a structure based on global markets (or channels) - yeast/bakery, industrial/food service, and consumer. The herbs and spices businesses were part of the consumer division (which included some vinegar and yeast) and part of the industrial and food service division (which also included some vinegar and yeast).

4. 1996 FINANCIAL STATEMENTS

4.1 Little information relating specifically to the performance and financial position of the herbs and spices businesses was separately disclosed in the monthly board reports, and in the annual financial statements, despite the fact that the herbs and spices business constituted 32% of sales for the year ending 30 June 1996. The herbs and spices businesses were reported together with other businesses in the consumer and industrial and food service divisions. This situation continued in the monthly reports until the decision to sell the herbs and spices businesses in May 1997, and in the annual financial statements until the writedown in September 1997.

Approach to tradename valuation

4.2 It was Burns Philp's stated policy to value tradenames at the lower of cost of acquisition or recoverable amount (defined in accounting standard AASB 1010 "Accounting for the Revaluation of Non-Current Assets"). "Cost of acquisition" was the amount of the total purchase price allocated to the tradename by Burns Philp at the time of acquisition. The stated policy was that, if the independent valuer determined a value of less than cost for any particular tradename, the value of that tradename was reduced to the independent valuation. No value was included in the balance sheet for tradenames developed internally by Burns Philp.

4.3 In 1996, determining and reporting on the value of non-current assets was governed by section 294(4) of the Law and accounting standard AASB 1010. Compliance with accounting standards was a requirement of section 298 of the Law. Other relevant provisions of the Law included sections 293 and 295B, which required directors to ensure that balance sheets were prepared to give a true and fair view of the state of affairs of the company and the group, and section 318 which required directors to take all reasonable steps to ensure compliance with the accounting provisions of the Law.

4.4 Between 1988 and 1996 Burns Philp retained Valuation Research Corporation (VRC), a North American firm, for the annual valuation of each separate tradename for the food businesses. Also in this period the company engaged Barings to review the VRC valuations, providing confirmation that the VRC valuations were prepared on a logical and consistent basis and were appropriate for inclusion in a note to the annual accounts. (VRC and Barings also valued the Burns Philp technologies.)

4.5 Obtaining a second opinion was prudent. With acquisitions, the value and relative significance of tradenames included in the Burns Philp financial statements increased as follows:

Tradenames as % of NCA	**1988**	**1989**	**1990**	**1991**	**1992**	**1993**	**1994**	**1995**	**1996**
* Tradenames at cost in $M	*42.9*	*120.6*	*140.6*	*178.9*	*194.5*	*391.7*	*458.0*	*604.2*	*501.7*
Total Non-Current Assets in $M	*842.3*	*1,026.2*	*1,160.8*	*1,094.6*	*1,308.3*	*1,695.5*	*1,862.7*	*2,209.0*	*1,881.9*
Percentage	***5.1%***	***11.8%***	***12.1%***	***16.3%***	***14.9%***	***23.0%***	***24.6%***	***27.4%***	***26.7%***

**It was Burns Philp policy not to amortise tradenames.*

4.6 The approach used by both VRC and Barings regarding the valuation of tradenames was the "relief from royalty" method, an approach widely viewed as appropriate for intangible assets such as tradenames. However it should also be acknowledged that an appropriate methodology for the valuation of intangible assets such as tradenames is contentious. On issuing international accounting standard IAS 38 in September 1998, the secretary general of the IASC stated, "Knowledge about intangible assets, particularly how to value them, is still in its early days... There is growing demand for further information on the value of intangible assets using financial and non-financial indicators, maybe not as a part of the financial statements."

4.7 Using the relief from royalty method, an amount of royalty is calculated as if another company owns the tradenames and a royalty is payable to that other company. The amount of royalty is usually a percentage of the revenue derived from the tradename products. This percentage depends on a number of factors including the nature of the assets, and the industry and geographic location in which the assets are employed.

4.8 Because the tradenames are, in fact, owned, a royalty is not payable. The calculated amount represents the "savings" resulting from ownership of the tradename. A value for each tradename is calculated based on these “savings”. A number of estimates are used in these calculations, including expected revenue, the royalty rate and the discount or capitalisation rate. Changes in any of these estimates can affect the resulting valuation significantly.

4.9 Specifically, for each tradename VRC applied a royalty rate to sales revenue forecasts prepared by Burns Philp for the next three years. A provision for income tax was subtracted and annual cash flows and a terminal value were determined. A discount rate was then applied to obtain the net present value, being the valuation of the tradename.

4.10 In reviewing the valuations, Barings used different estimates. For example, Barings used different royalty rates, and, to derive maintainable sales revenue, used an average of actual sales revenue for one year and forecast sales revenue for the following year. Barings also used an alternate calculation method which required a capitalisation rate instead of a discount rate. Factors such as the price-earnings multiples of listed food companies were considered to determine the capitalisation rate.

4.11 The following information on valuations at cost and at independent valuation was obtained from the annual reports of Burns Philp:

Tradename Valuations	**1988**	**1989**	**1990**	**1991**	**1992**	**1993**	**1994**	**1995**	**1996**
*Tradenames at cost in $M *(shown in the balance sheet)*	*42.9*	*120.6*	*140.6*	*178.9*	*194.5*	*391.7*	*458.0*	*604.2*	*501.7*
Valuation by VRC in $M *(shown in a note to the accounts)*	*Details not available*	*360.0*	*390.0*	*390.0*	*445.0*	*800.0*	*905.6*	*1,121.4*	*1,014.6*

**Note: Until 1995 tradenames included the hardware business as well as food and fermentation.*

4.12 The directors have stated that, in their annual review of the values of non-current assets required by AASB 1010 and section 294 of the Law, the size of the difference between cost and independent valuation (shown above) provided reassurance that the carrying values were not overstated. However it is notable that “Tradenames at cost” does not include the internally generated tradename values, while the “Valuation by VRC” does include these additional tradename values.

$30.7 million reduction in tradename values

4.13 The VRC and Barings reports were reviewed by the audit committee in discussion with Burns Philp management and KPMG, the auditors. In 1996 there was a significant difference in the amounts attributed to tradenames in the VRC valuation and the Barings review. KPMG considered this difference to be so great they recommended that Burns Philp obtain a third expert opinion. Accordingly, Burns Philp retained Schroders from mid-August to early September to review the methodology and assumptions of VRC.

4.14 Like Barings, Schroders used the capitalisation method within the relief from royalty framework. However, Schroders considered only a sample of the intangible assets, including the larger tradenames. Schroders concluded that the VRC valuations could be overstated by as much as 37%. In their report to Burns Philp, Schroders stated:

> "In our opinion, until management has discussed the reasonability of the assumptions used and, in particular, the areas of sensitivity identified by Schroders in this review, BPC should not rely on the VRC valuation."

4.15 Concerned that there could be no reliable valuation for the 1996 accounts, management at Burns Philp asked Schroders to retract or modify its report. Schroders declined. Subsequently Burns Philp asked VRC to review its approach, and provided the Schroders report to VRC to enable the valuer to consider the matters raised in that report. VRC then significantly reduced the value of some tradenames using modified assumptions. (Barings was not aware of the negotiations with Schroders and was not called upon to review this further work by VRC.)

4.16 At the request of KPMG, Schroders subsequently provided Burns Philp with a further letter in respect of the revised VRC valuations. This letter stated:

> "if Burns Philp's management and its auditors are satisfied with VRC's assumptions in relation to tax and discount rates, Burns Philp could conclude that the revised VRC valuation of the brands and technologies provides an appropriate indication of value for disclosure in the 1996 financial statements."

4.17 KPMG undertook further work to obtain satisfaction about the tax and discount rates, and on the basis of the assurance provided by this further work, the revised VRC valuation report, the Barings and Schroders reviews and the audit committee's recommendations to the board, the value of Burns Philp's tradenames was reduced by $30.7 million in the 1996 financial statements.

The 1996 result - a loss of $54.8 million

4.18 As noted above, in May 1996 the directors decided to address the problems in the North American herbs and spices businesses in the June 1996 financial statements. These problems, and other matters led to the following charges being made against profit:

- $53.1 million for rationalisation costs, primarily in North America, including equipment and inventory write offs, and new packaging conversions. The consolidation of herbs and spices operations at Ankeny had been more expensive than anticipated;
- $33.9 million for unprofitable slotting contracts;
- $30.7 million for tradenames, (as noted above) reflecting declining profitability;
- $18.2 million for project start-up costs;
- $10.1 million for pre-launch costs for new products which did not meet sales and profit expectations; and
- $6.4 million for Estate Mortgage costs.

4.19 Including these items, the after tax result was a loss of $54.8 million, the worst result in the 113 year history of Burns Philp.

The auditor and the audit committee

4.20 Regarding the monthly financial reports to the board, the auditor, KPMG, stated in its audit debriefing report to Burns Philp, dated 23 August 1995:

> "Whilst the board report provides a large amount of detail, the critical issues are not always easily discernible. Board reporting could be improved to provide a more concise review of critical issues in addition to the detailed commentary on the results already provided. In particular the performance of new acquisitions could be addressed in more detail dealing with the impact of acquisition accounting and discussing underlying performance against original expectations."

and

> "The culture of requiring aggressive budgets has led to some cynicism 'down the line' about the likely achievement of budgets and has also manifested itself in examples of achieving EBIT by aggressive accounting. Examples include the creation of pre-acquisition provisions, early recognition of profits and the deferral of costs... it is important that the culture which has been built up in some divisions be addressed."

4.21 A year later, on 29 August 1996, KPMG presented a paper to the board which had been developed in conjunction with the audit committee and the new chief financial officer. This paper expanded on the issues identified in 1995, stating,

> "*We believe a major cultural change needs to be driven throughout the Group.*"

4.22 In relation to reporting on business performance, it was stated that:

"Monthly Board reporting currently focuses on sales, EBIT, NPAT and working capital but contains little or no information on gross margins or return on assets and other key performance indicators. It is not possible to determine from the reports, for example, key information (margins, return on investment, etc.) from the spice businesses..."

To put this comment in perspective, the herbs and spices businesses represented 32% of sales for the year ending 30 June 1996.

KPMG went on to suggest:

"*The inclusion of key performance indicators ("KPI") such as gross margin percentages, return on assets by product type and other operating statistics would significantly improve the quality of board reporting.*"

4.23 KPMG discussed the North American restructuring process, as an example:

"The significant increase in abnormal re-structuring costs this year which was only picked up at year end by the CFO spending time in North America, is an example of poor management, poor reporting and lack of accountability and highlights the problems of corporate management being too far away from the operations."

4.24 In relation to the choice of accounting treatments, it was stated that:

"Accounting treatments often appear to reflect a level of optimism which often does not reflect the risks associated with particular transactions."

One example was the deferral of slotting fees for new products. KPMG suggested that there should be a board approval process, and that:

"To justify the deferral of costs and period of amortisation, the request for Board approval should specify the justification of the carry forward of costs, the hurdles which must be met for continued deferral of those costs, and the risks and assumptions underlying the analysis."

4.25 In relation to the focus of reporting, it was stated that:

"*The development of an 'EBIT culture' rather than detailed analysis of the emerging issues underlying business performance has been a major issue.*"

"The pressure to achieve 'top line' results to meet expectations which have been given to the market has led to many examples of optimistic and 'one-off' accounting changes/treatments."

4.26 The auditors concluded:

"We recommend that a review of the Group's information systems, Board reporting and key performance indicators be undertaken. The restructuring of the Group into channels and recent senior appointments provides an appropriate catalyst for the review together with a study of best practice in management and Board reporting by similar listed companies."

4.27 The above observations by the auditor related to the overall business of Burns Philp. Nevertheless, there is no reason to believe that these comments did not relate to the herbs and spices component of the business. In fact, the comment in paragraph 4.22 relates specifically to the spice business.

The response of the board

4.28 In interviews with ASIC, past and current directors indicated that, following the substantial writedowns in the June 1996 financial statements and consideration of the matters raised by KPMG, the board believed the major issues facing the herbs and spices businesses were being addressed. The monthly reports to the Board were restructured. New managers were in place and the new global reporting structure was implemented. It appeared that the slotting war was declining and might in fact cease, given a proposed US Federal Trade Commission investigation into the practice of slotting payments. The directors believed that Burns Philp, including the herbs and spices businesses, would move into a new era of profitability. Andrew Turnbull, the chairman, stated in the 1996 annual report,

"During the year we responded to the disappointing performance of the company by implementing a new focused management structure and appointing internationally experienced managers within the top levels of the company... The abnormal loss reflects the Board's determination to provide a realistic foundation for the future of the company."

4.29 Burns Philp has advised that a major program of initiatives was also put in place at this time to improve efficiency. However, the company has also advised that these initiatives were not fully implemented due to the decision in May 1997 to sell the herbs and spices businesses.

5. NOVEMBER 1996 TO MAY 1997

Management conferences

5.1 The executive committee, comprising the managing director, Ian Clack, and the heads of human resources, John Dyer; yeast/bakery, John Cowling; industrial/food service, Ned Skinner; consumer foods, John Cook; and finance, John Chapman, met on 13 and 14 November 1996. Their objectives were to develop the management team and to find ways to improve company performance.

5.2 A second meeting was held from 29 to 31 January 1997, to address the financial position, management competence and system capabilities of Burns Philp - including concerns raised in the KPMG paper to the board dated 29 August 1996. The executive committee and the next tier of management attended this meeting - in total about 30 people.

5.3 John Chapman drew to the attention of this second meeting that, in the past ten years, Burns Philp shareholder returns had significantly underperformed the market average. During this meeting the overall Burns Philp strategy was reconfirmed. In addition, it was decided to improve the company's systems for strategic planning, budgeting and communications, and to form a new executive management team to integrate the recently appointed senior managers.

5.4 Subsequent reports by John Cook and Ned Skinner to the Burns Philp board in April 1997 encouraged the view that the problems in the herbs and spices businesses had been identified and would be overcome.

Worse than expected results

5.5 Following the writedowns and the $54.8 million loss in June 1996, there was a net profit of $17.6 million for the first quarter of 1996/1997. This result was very close to budget. However these results were not sustained in the following months, as shown below.

Monthly Group Profit/(Loss) after tax and abnormals in $M	**Nov 1996**	**Dec 1996**	**Jan 1997**	**Feb 1997**	**Mar 1997**	**Apr 1997**	**May 1997**
Actual	*9.2*	*5.8*	*(12.8)*	*(13.0)*	*3.2*	*(14.0)*	*(20.7)*
Budget	*15.2*	*13.3*	*(6.3)*	*2.8*	*13.2*	*7.7*	*5.0*
Amount by which budget exceeded actual results in $M	***6.0***	***7.5***	***6.5***	***15.8***	***10.0***	***21.7***	***25.7***

5.6 As noted above, little information about the results of the herbs and spices businesses was separately disclosed to the directors in the monthly financial reports, and to the shareholders in the financial statements. However, subsequent analysis suggests that the significantly worse than expected results came principally from the herbs and spices businesses. Factors contributing to the below-budget results for herbs and spices were: the ongoing costs of the Ankeny consolidation, competitive pressure in Germany, the impact of slotting fee amortisation, increases in the cost of pepper, and a decrease in the size of the consumer herbs and spices market in North America.

5.7 In February, concerned about this state of affairs, John Chapman suggested that Boston Consulting Group (BCG) be employed to review the strategy and operations of the company. Ian Clack approved this proposal and BCG commenced its review in March 1997.

Disruptions in management

5.8 A compounding factor was the absence of strong guidance from the appointed chairman of the board. Due to illness, Andrew Turnbull was frequently absent in the period from July 1996 to May 1997. William Irvine, Mark Burrows and Alan McGregor acted as temporary substitutes. It was only after Andrew Turnbull's death, on 14 May 1997, that Alan McGregor was appointed as chairman.

5.9 There was no president of industrial/food service for some months in 1996. Ian Clack, managing director, undertook this additional duty until the appointment of Ned Skinner, in November 1996.

Financial pressures - business development requirements and Estate Mortgage

5.10 In April 1997 senior managers made reports to the board about the future prospects of Burns Philp businesses. John Cook, president of consumer foods, stated that more time and resources were required to solve the problems with herbs and spices. John Cowling, president of yeast/bakery, sought additional funds to develop the yeast business. Ned Skinner, president of industrial/food service, requested additional funding to complete the rationalisation at Ankeny and to address problems with production processes in Europe.

5.11 The board knew that all three funding requests could not be met as the company's financing capacity was limited. Burns Philp could not issue more debt. Even before the 1997 writedown of asset values the company was highly geared and close to the limit prescribed by its debt covenant. Nor was a share issue considered viable.

5.12 In addition, substantial funds were required to settle the Estate Mortgage litigation. Burns Philp Trustee Company Limited had become trustee for the Estate Mortgage trusts in 1983. Early in 1990 the trusts had liquidity problems. By September 1990, borrowers and lenders had commenced legal action against the company, and in October 1990 Burns Philp Trustee Company Limited went into liquidation. In 1991 the new trustees sought compensation for breaches of trust from Burns Philp Trustee Company Limited and from Burns Philp & Company Limited. A settlement of $90 million in cash and $26 million in convertible notes was finally agreed on 20 July 1997.

5.13 In anticipation of such a settlement payment, in late 1996 Burns Philp had renegotiated the covenant for its debt to equity ratio, increasing the limit from 90% to 120%. However, in consequence of this negotiation, the banks became aware of the problems in the herbs and spices businesses, and increasingly pressured Burns Philp to cut costs and sell assets to reduce debt.

The decision to sell the herbs and spices businesses

5.14 BCG presented its report to the board on 19 May 1997. This report disaggregated the businesses in the industrial/food service and consumer channels to enable separate consideration of the yeast/bakery, herbs and spices, ingredients, and other businesses of Burns Philp.

5.15 Regarding the North American herbs and spices business, BCG advised that, “with all of NA H&S initiatives, this operation will not break even by year 2000” and “even with successful implementation of initiatives, progress will be slow and returns remain inadequate”. Regarding the European herbs and spices businesses, BCG advised, “Europe has also suffered from implementation issues resulting in a weak competitive position” and that, “achieving upside for Europe will ensure it is EBIT positive by the year 2000”. BCG advised that the herbs and spices businesses would be more valuable in the hands of an established US food conglomerate with lower costs for sales, packaging and distribution.

5.16 BCG’s view was that the due diligence on acquisition of the businesses may have been inadequate and the herbs and spices businesses may have been overvalued. In their view, in the subsequent management of the businesses there were unrealistic expectations, a lack of understanding of market dynamics, poor planning and a tendency to hide bad news, leading to poor performance and high costs. When interviewed by ASIC, some board members said that it was not until the presentation by Boston Consulting Group on 19 May 1997 that the extent of the herbs and spices problems became apparent to them.

5.17 In the face of competing requirements for finance, the board decided that the herbs and spices businesses should be sold, and that the proceeds should be used to retire debt, pay the Estate Mortgage settlement, strengthen the successful yeast business, and stabilise the company’s financial position. With such a significant change in strategy, Ian Clack and John Cowling resigned on 19 May 1997.

5.18 In April 1997, Barings had been appointed to prepare a valuation of the herbs and spices businesses, based on the work undertaken by Boston Consulting Group. On 19 May, Barings provided two potential valuations, the first being a value in the range of $615 -$890 million, which included the significant synergies that a major food group could achieve, for example, by improved slotting terms and reduced administration costs, and the second being a stand-alone value in the range of $210-$290 million for the businesses without such synergies. At this time, stockbroking analysts estimated that the sale of the herbs and spices businesses would yield $400-$800 million.

6. THE SALE PROCESS

6.1 Ian Clack had agreed to remain until the new managing director was appointed, and also undertook to manage the sale of the herbs and spices businesses. (Ultimately he departed Burns Philp on 29 August 1997.) In May 1997, Barings was appointed to advise on the sale of the herbs and spices businesses. The board decided that the businesses should be sold before the issue of the annual accounts in September 1997. There were restrictions on Burns Philp's capacity to borrow and the company needed funds for working capital. This five month timeframe was viewed as tight but reasonable.

6.2 During May and June 1997 copies of an information brief and confidentiality agreement were sent to all interested parties. From 14 July a detailed Information Memorandum was sent to all parties who had signed the confidentiality agreement. Eighteen preliminary non-binding offers were received in August 1997, the highest bid being $600 million. One of the offers was from Ned Skinner, who led a management buyout team. This offer by a well-informed and highly regarded manager reassured the board about the viability of the herbs and spices businesses.

6.3 During August and September Burns Philp made presentations to interested parties in Europe and North America. Also during that period, potential buyers conducted due diligence on the herbs and spices businesses. More than one hundred parties had expressed an initial interest in the herbs and spices businesses. However, by the deadline for final bids on 17 September 1997, only four offers had been received. Of these, the management buyout offer was preferred. It was the highest bid and the only offer for the herbs and spices businesses in their entirety. Accordingly, priority was given to discussions in relation to this offer.

6.4 In late September 1997, Graham Hart took over negotiations with the management buyout team led by Ned Skinner. As the other offers had been withdrawn, the offer made by this team was the last remaining offer for the herbs and spices businesses.

6.5 After the financiers for the management buyout team completed their due diligence, this final offer was withdrawn on 5 November 1997, the date of the Burns Philp annual general meeting.

6.6 In considering why all the offers were withdrawn, Barings noted that some interested parties viewed the herbs and spices businesses as "turnaround", requiring a long period to solve the problems. Barings also noted the concerns of many parties regarding the likely amounts of future slotting payments.

6.7 Additional explanations were subsequently offered by advisers to, and senior officers of, Burns Philp:

- The herbs and spices businesses were highly integrated with yeast/bakery and other businesses. Purchasers would have had difficulty in understanding the precise paramaters of the herbs and spices businesses. As well, there would have been high costs to establish new administrative structures for the disaggregated herbs and spices businesses.

- Prospective purchasers could not act confidently because they could not obtain sufficient information about the costs of the herbs and spices businesses. For example, administration for all the North American Burns Philp businesses was centralised and administration costs were allocated to the various businesses. This was "a cause of concern to potential purchasers who queried the objectivity and basis of cost allocations."
- Purchasers were concerned about the competitive response from McCormick.
- Purchasers perceived the offer as a forced sale.
- The sale process resulted in customer uncertainty, and in the loss of customers, managers and employees.
- A number of other significant food assets were in the market at the same time as the Burns Philp's herbs and spices businesses, increasing the range of options for bidders.
- It was intended to sell the herbs and spices businesses in a relatively short timeframe - between May and September 1997. These months included the summer vacation period in the northern hemisphere, which decreased the time available for potential buyers to investigate the businesses.
- There were ongoing production inefficiencies as the Ankeny rationalisation was not complete. In addition, the herbs and spices management team was not well-established, having been assembled in a short period from staff in the separate consumer foods and industrial/food service divisions.

7. THE WRITEDOWN - 24 SEPTEMBER 1997

7.1 After the decision to sell the herbs and spices businesses, there were changes in key personnel. Tom Degnan was appointed managing director on 3 September 1997. He was previously vice president of yeast/dehydrated foods and the Asia Pacific divisions of Universal Food Corporation (Burns Philp's major competitor in the US yeast market).

7.2 Graeme Hart became a substantial shareholder of Burns Philp in June 1997. He was appointed a director on 22 September 1997, and deputy chairman on 24 September 1997.

7.3 At the board meeting on 24 September 1997 a decision had to be made about the values of the unsold herbs and spices businesses to be included in the 1997 annual accounts. John Chapman circulated the following information on valuations.

Source of valuation	**Valuation - $M**
Boston Consulting Group	*240*
Barings	*250-325*
Burns Philp estimate of the value of the businesses as a going concern	*600*
Current book value	*850*

7.4 The amount offered by Acquisition LLC, the management buyout team, was US $210 million, less liabilities of US$63 million (as at 30 June 1997). That is, the offer was US$147 million, based on certain assumptions. This was the only offer extant at the meeting on 24 September 1997. Graeme Hart said that the valuation must reflect the amount which could be realised from the sale of the herbs and spices businesses. In line with this conservative approach, he proposed that the herbs and spices businesses be valued in the 1997 financial statements at A$150 million. A unanimous resolution was passed accordingly.

7.5 The financial statements released on 26 September 1997 included the following writedowns with respect to the herbs and spices businesses:

Abnormal Items - Herb and spice businesses	**$ million**
Business rationalisation costs, plant and equipment and working capital write-downs	*(188.1)*
Write-down of product slotting contracts	*(136.4)*
Write-down of intangible assets	*(435.5)*
TOTAL	*(760.0)*

Neither the valuer nor the reviewers were involved in these writedowns.

8. REFINANCING AND RESTRUCTURING THE COMPANY

8.1 Due to the writedown of assets in the 1997 financial statements, and because the herbs and spices businesses had not been sold (with a consequent lack of funds to retire debt), Burns Philp was in breach of its borrowing covenants. The allowable ratio of debt to equity was 120%. After the writedown, the ratio was 354%. Burns Philp obtained a moratorium from its banks to allow refinancing.

8.2 An extraordinary general meeting was held on 26 February 1998. At this meeting Burns Philp shareholders agreed to raise $300 million by the placement of $250 million notes and associated options with the company's four largest shareholders, and by a subsequent renounceable rights issue of $50 million notes and associated options to all shareholders.

8.3 Following the writedown in the herbs and spices businesses the company has implemented a program of rationalisation and reconstruction. The financial statements for the half year to 31 December 1997 included $54.5 million in costs for restructuring the herbs and spices business, $13.4 million in costs for restructuring corporate and administrative units, $49.2 million in net foreign exchange losses, $88.5 provision for loss on sale of businesses, and a $48.5 million writedown of future income tax benefits, being a total of $254.1 million.

8.4 The financial statements for the year ending 30 June 1998 stated:

"The Company retained the yeast, bakery ingredients, North American herbs and spices and Terminals businesses. All other businesses and assets were sold... The proceeds of asset sales and the recapitalisation plan, approximately $521 million, have been used to reduce debt. The remainder of Burns Philp's debt has been refinanced, on a three year term with the Company's banks."

8.5 In an announcement to the Australian Stock Exchange dated 9 September 1998, Burns Philp stated that restructuring since the announcement of the asset writedown on 24 September 1997 included:

- the reduction of bank debt through the sale of non-core businesses and the issuance of notes and options to the group's three main shareholders.
- the reduction of corporate overheads in Sydney and in the United States.
- the restructuring of the North American herbs and spices business. There have been reductions in staff numbers, inventory, the number of product lines and in overhead costs.

9. ISSUES OF CONCERN

9.1 ASIC's enquiry has led it to the view that there was no sufficient change in circumstances to explain the drastic alteration in the value of the herbs and spices businesses between the issue of the 1996 financial statements and the 1997 financial statements. While events in late 1996 and early 1997 contributed to declining performance, preceding events also contributed to the loss in value of the herbs and spices assets. It appears that the values attributed to the herbs and spices assets in the 1996 financial statements may have been materially overstated. Some of the factors leading to this overstatement are discussed below.

Reports to the board on the performance of the herbs and spices businesses

9.2 Participation in the herbs and spices market was a new venture for Burns Philp. As risk attached to this venture, it would have been reasonable to expect the board to require detailed monthly reports on the performance of the businesses in this new market. However, during key years of Burns Philp's involvement with herbs and spices, the monthly board reports did not dissaggregate the results sufficiently to show the performance of the herbs and spices business separately from the other businesses of Burns Philp.

9.3 As noted above, results were reported according to global markets - principally yeast/bakery division, consumer division and industrial and food service division. However the composition of some of these divisions varied from one location to another. For example, in the first half of the 1995-1996 year, there was reporting about the category "spices" in Europe. This category was replaced in the second half of the 1995-1996 year, when it appears that some European herbs and spices were included in the industrial division. The company has advised that herbs and spices were not included in the industrial division in North America. The consumer division in North America included some yeast and vinegar as well as retail herbs and spices, while it appears that the consumer division in Europe may have been composed entirely of herbs and spices. The company has advised, "The description of the summarised information presented in the reports to directors may be confusing to those not familiar with the information categories. The directors were familiar with those categories." It is notable that the 1995-1996 monthly financial reports to directors did not provide clarification or supporting definitions of these categories.

9.4 The company has also stated, "The information available for the Board to consider was not inadequate. Detailed financial information on the herbs and spices business was always on record with Burns Philp." However, as noted at paragraph 5.16 above, some board members told ASIC that they only became aware of the extent of problems in the herbs and spices businesses on 19 May 1997, during the presentation by Boston Consulting Group.

9.5 As discussed above, in 1995 the auditor stated to the board its concerns about inadequate reporting to the board. Management did not inform the board about critical issues and risks, the performance of specific businesses, or corrective action to address the failure to meet budgets. The subsequent monthly reporting to the board was still inadequate in 1996, giving rise to further observations by the auditor (also noted above).

9.6 During the 1996-1997 year some improvements were made to the monthly board reports. However, in the prior critical years of involvement in the herbs and spices businesses, it appears that detailed information was not available to the board.

The need to check the validity of information provided to the independent experts

9.7 The valuation report and the review reports commissioned by Burns Philp clearly stated that the source data used to prepare the valuations was obtained from Burns Philp. For example the VRC report stated, "In the course of our investigation we have received and reviewed information provided by the company. Much of this information relates to historic and projected revenue and operating results for various reporting groups and products of the company. We have accepted this information as an accurate representation of the actual results to date and as reasonable estimates of future sales and financial performance."

9.8 As noted above, in 1995 the auditor drew to the attention of the board a tendency for the development of aggressive forecasts. It appeared that this was still the case to some extent in 1996. While the monthly reports to the board for the year ending 30 June 1996 show that actual revenue was frequently fairly close to forecast revenue, there were exceptions. For example, the forecast revenue for North America consumer division (which used a substantial number of tradenames) was significantly greater than actual revenue in the second half of the year, as shown in the following table.

Period	**July 1995**	**Aug 1995**	**Sept 1995**	**Oct 1995**	**Nov 1995**	**Dec 1995**	**Jan 1996**	**Feb 1996**	**Mar 1996**	**Apr 1996**	**May 1996**	**June 1996**
Forecast Revenue in AUS $M	*20*	*29*	*55*	*75*	*57*	*55*	*29*	*29*	*42*	*31*	*28*	*36*
Actual Revenue in AUS $M	*21*	*26*	*56*	*63*	*59*	*49*	*21*	*23*	*36*	*21*	*15*	*25*

9.9 No evidence has been obtained from the minutes of the board or audit committee meetings to show that the directors took steps to satisfy themselves of the validity of the source data used by the valuer or reviewers, even though the auditors had stated to the board that there were serious concerns about the quality of information in the monthly financial reports, and VRC, Barings and Schroders had clearly stated that they relied on management data.

The need to test for reasonableness the asset valuations prepared using the "relief from royalty"method

9.10 The relief from royalty method was used by VRC, Barings and Schroders. While this method may be appropriate for the valuation of tradenames, it is fundamental to the use of this method that the resulting valuations be tested. As noted above, large changes in the valuations can result from relatively small changes in the revenues, royalty rates and discount rates used in calculating the valuations.

9.11 One reasonableness check is to ask whether sufficient net profit has been derived from the use of a tradename to enable payment of the royalties. In the relief from royalty method, the valuer calculates the amount of royalty payable if the company did not own the tradenames. The company itself has information about net profit, being sales revenue minus all relevant expenses, including administration, marketing and the slotting and reconstruction costs related to the use of that tradename. There should be sufficient net profit from the use of the tradename to enable the additional payment of royalty expenses. If the royalties are so large that there is insufficient profit to pay for them, the valuation based on those calculated royalties could not be supported by the earning capacity of the tradename. Accordingly smaller royalty amounts should be used to calculate the tradename value and, in consequence, the valuation is be reduced.

9.12 Another approach is to consider the “royalty cover”, a concept similar to “interest cover”. This indicates the capacity of the entity to pay royalties. Again, information about calculated royalties is available from the valuer, and the company itself has information about profit. To sustain the tradename values derived by VRC, the implication was that Burns Philp had the capacity to make significant royalty payments each year. The question arises as to whether the profits earned by Burns Philp were sufficient to enable the payment of such royalties. If the royalty payments could not have been made, the tradename values should have been written down to a sustainable level. The amount of herbs and spices intangible assets ultimately written down in 1997 was $435.5 million, an amount substantially comprising tradenames.

9.13 The information for both these reasonableness checks should have been readily available to the directors of Burns Philp. The directors could have undertaken such reasonableness checks themselves, or requested that such checks be undertaken.

9.14 To illustrate, the following information refers to a comparatively small Burns Philp business in the United Kingdom, British Pepper & Spice acquired in 1993 (and sold in May 1998).

	1994	**1995**	**1996**
Earnings before interest & tax (EBIT) in $M *(details from management accounts)*	*0.07*	*(0.7)*	*(0.6)*
Contribution to group profit/(loss) in $M - after interest and tax *(details obtained from annual reports)*	*(0.8)*	*(1.9)*	*(3.2)*
Tradename valuation by VRC in $M *(details obtained from valuation report)*	*1.3*	*1.9*	*1.5*

9.15 Each tradename valuation took account of royalties for the current year and for future years, while the EBIT and each contributed loss related only to the current year. Depending on the amount of interest payable in 1994, the company may have been able to pay royalties in 1994, although, from a business perspective, after the payment of interest and royalties there may not have been a satisfactory return on investment. However it is apparent that royalties could not have been paid in 1995 and 1996 as the company sustained losses.

9.16 A poor result in one year could have indicated a temporary impairment in tradename values. However, ascribing a value to tradenames used by a business which is incurring continuing losses is inappropriate without careful analysis of the circumstances. In the case of the Pepper and Spice tradenames the ongoing losses raise questions as to how the tradename values could be supported and why they were not significantly written down in 1996.

9.17 In checking the reasonableness of tradename values, an even more accurate analysis would be obtained by considering net profit from each tradename, rather net profit from the entire business. Nevertheless, when most profit derives from tradename products, a comparison of the net profit of the business with tradename values can provide a guide to the reasonableness of tradename values, and hence provide the directors with either some assurance, or a basis for questioning the valuer about the valuation process and assumptions.

9.18 It appears that a similar situation arose, on a much larger scale, for some of the North American herbs and spices tradenames. The expenses of consolidation at Ankeny and slotting amortisation impacted heavily on the results of the North American herbs and spices businesses.

9.19 A similar concern arises in relation to the results for the entire Burns Philp Group:

	1989	1990	1991	1992	1993	1994	1995	1996
Tradename valuation by VRC in $M	*360.0*	*390.0*	*390.0*	*445.0*	*800.0*	*905.6*	*1,121.4*	*1,014.6*
Operating profit/(loss) including abnormal items before income tax in $M	*64.0*	*68.4*	*79.5*	*129.5*	*147.8*	*155.6*	*131.4*	*(37.3)*

9.20 Burns Philp has put the view that, when determining tradename values, it was not appropriate to take account of all the expenses relating to the use of the herbs and spices tradenames. Expenses such as upfront slotting fees and the Ankeny restructuring costs were seen as short term expenditure which supported the achievement of long term strategy by increasing economies of scale and market share. In addition, while this short term expenditure was substantial, sales were buoyant and there was no reason to expect that sales of tradename products would diminish in future. Accordingly, it was reasonable to disregard the impact of short term expenditure. However, given the size and the duration of these expenses, it was questionable whether such an approach could be justified.

9.21 It appears that the directors relied on the valuations and reviews prepared by the independent experts and on the assurances provided by the auditors. During its enquiries ASIC obtained no evidence that the directors themselves conducted any reasonableness checks such as those discussed above. Nor was any evidence obtained which indicated that the VRC intangible asset valuations were challenged by the directors in the light of their overall knowledge of the business.

Board understanding of the valuation and review reports

9.22 As noted above, in 1996 Burns Philp received reports from three experts - VRC (the valuer) and Barings and Schroders (the reviewers). In each case the reports included assumptions which limited the reliance that could be placed on the tradename valuations determined by the experts.

9.23 The VRC report stated, in explaining the basis for preparing the report, “This value definition assumes the appraised assets continue in their current use as part of the ongoing business. It also assumes that earnings from operations are adequate to justify the investment in the appraised assets at the concluded fair market value.” This implies that, to justify acceptance of the VRC valuations, the directors needed to consider the tradename values in relation to the earnings from those tradenames.

9.24 The Barings report stated, "it is crucial to value a technology or tradename separately from the business which seeks to utilise it. The fact that the asset is being exploited to a particular level, or is capable of being exploited beyond the use to which it is currently being put, should not affect a valuation of the asset itself." This long term view is similar to the view held by Burns Philp and suggests that current practical issues such as the quality of management and competitive conditions are irrelevant in determining the intrinsic value of a tradename. It does not appear that the directors considered whether the Barings assumptions were appropriate in the light of their overall knowledge of the business, for example, regarding the returns currently being achieved from actual use of the tradenames.

9.25 It is worth noting that, if a business does not exploit a tradename to its full potential, shareholder return may be maximised by selling the tradename rather than by earning less than maximum profit from its use.

9.26 The approach used by Barings has also been considered in the light of accounting standard AASB 1010. This standard states that a non-current asset cannot be valued at more than its recoverable amount, being the net amount expected to be recovered through the cash inflows and outflows arising from the continued use and subsequent disposal of the asset. There is a question as to whether "continued use" requires that factors such as the quality of management and competitive conditions should be considered annually, or on a longer term basis.

9.27 Barings stated that, as the tradenames were non-current assets, a long term view of "continued use" was appropriate. Burns Philp had clearly stated a long term strategy to increase market share and reduce production costs by the payment of slotting and reconstruction costs. It was intended that these costs would would diminish in future years and hence a long term value of tradenames was appropriate.

9.28 In accepting a report based on these assumptions it appears the directors may not have distinguished between the intention stated in Burns Philp's long term strategy, and the need for the company to report actual progress in implementing that long term strategy on an annual basis.

9.29 In its final observations to Burns Philp, Schroders stated, "if Burns Philp's management and its auditors are satisfied with VRC's assumption in relation to tax and discount rates, Burns Philp could conclude that the revised VRC valuation of the brands and technologies provides an appropriate indication of value for disclosure in the 1996 financial accounts." That is, the VRC valuations could be relied upon only if the assumptions relating to tax and discount rates were sound. Barings was not called upon to undertake additional work in relation to the revised VRC valuations. As noted above, KPMG provided the necessary assurance to Burns Philp regarding the tax and discount rates.

9.30 While the matters raised in the Schroders report were addressed, ASIC obtained no evidence during its enquiries that the assumptions in the VRC and Barings reports were specifically addressed by the directors, or that the directors took into account the effect of these assumptions when considering the values of tradenames.

Auditor reliance on the valuation reports

9.31 Auditing standard AUS 606 “Using the Work of an Expert” requires that the auditor assess the work of any experts employed, to obtain satisfaction that the experts’ reports can be relied upon. In this case the experts were VRC, Barings and Schroders, who were employed by Burns Philp to report in relation to tradename values.

9.32 In particular, AUS 606 requires that the auditor determine whether the expert has used source data which is appropriate in the circumstances. In this case, the valuer (VRC) and the reviewers (Barings and Schroders) did not undertake any testing of the data provided by Burns Philp. In addition, KMPG had concerns about the source data and some of the intangible asset valuations prepared by VRC. This knowledge is exemplified in KPMG’s 1995 and 1996 post-audit reports to Burns Philp, which state that the company produces “optimistic financial forecasts” and engages in “aggressive accounting”. The auditor would also have had regard to the fact that the intangible asset valuations were material and high risk.

9.33 In these circumstances, it would have been appropriate for the auditors to confirm that the experts did, in fact, use the data provided by Burns Philp. It would then have been appropriate for the auditors to make enquiries of Burns Philp to determine whether the assumptions and bases used in developing this source data were reasonable.

9.34 KPMG did alert Barings and Schroders to matters of concern relating to the valuations, including the validity of the source data. KPMG and Barings discussed these matters face to face. Schroders was advised of KPMG’s concerns by letter. The Schroders report dated 20 August 1996 stated that “Schroders has reviewed BPC Food Division’s budgeting record over the past two years and determined that actual sales in 1995 and 1996 were approximately 8-10% below budget.”

9.35 However, despite the auditor’s knowledge and concerns, KPMG audit staff have stated that they did not undertake any independent check of the source data provided by Burns Philp to the valuer and reviewers. To determine whether the intangible assets were appropriately valued, the auditors stated that they relied on the Schroders conclusions.

Comparison of intangible valuations at cost and at independent valuation

9.36 The accounting policies in the annual report state that only purchased tradenames are included in the financial statements. Other documents obtained during ASIC's enquiry indicate that the valuation prepared by the VRC includes all the tradenames of Burns Philp, both purchased and developed internally.

9.37 The directors' comparison of tradenames at carrying value and at independent valuation, as shown in the notes to the accounts, was a comparison between two different groups - the smaller group of purchased tradenames and the larger group of all tradenames.

9.38 It would have been better disclosure to show separately the independent valuation of purchased tradenames and the independent valuation of internally developed tradenames. Such disclosure would have revealed a smaller margin of safety.

The role of the audit committee

9.39 While the directors comprising the audit committee might to some degree have been delegated the responsibility to review the carrying value of intangible assets, given the fundamental importance of intangible asset values to the Burns Philp balance sheet and debt covenants it might have been appropriate for the entire board to consider the issues raised in paragraphs 9.7 to 9.30 above. In relation to corporate governance, the 1996 annual report stated:

> "The Board is responsible for the overall governance of the company and its strategic direction. This includes the setting of goals, monitoring performance and ensuring the company's internal control and reporting procedures are adequate, effective and ethical."

The position of the chairman of the board

9.40 Andrew Turnbull was managing director of Burns Philp from 1984 to 1994. He was chairman of the board from 1994 until his death in 1997. Information provided to ASIC indicates that, after becoming chairman, he continued to strongly support the strategy he implemented as managing director. Former and current directors have stated that this led to factionalism in the board. This division was not subsequently resolved, as the chairman was absent for most of his tenure, with other directors acting as temporary substitutes. The appointment of a former chief executive officer as chairman of the board lessened the separation of the functions of board and management. This, combined with the absence of the chairman due to illness, meant that the board did not have the leadership to ensure the necessary critical review of management.

10. ACCOUNTING ISSUES

10.1 The regulatory framework in place in 1996 and 1997 provided sufficient guidance to directors about their reponsibilities regarding asset valuations. The case of Burns Philp highlights the need for directors to be particularly vigilant when assessing valuations provided by independent experts for the purpose of determining appropriate asset values for financial statements. However ASIC notes that there have been significant developments in the accounting framework since that time.

10.2 The Company Law Review Act 1998, which amends the Corporations Law, has removed section 294 of the Law. This section related to the valuation of assets. Reliance is now placed on accounting standard AASB 1010 "Accounting for the revaluation of non-current assets". This amendment has eliminated the possibility of confusion arising from the simultaneous application of section 294 of the Law and AASB 1010.

10.3 By their nature, intangible assets are difficult to value. The following developments are noted:

- The international accounting standard IAS 36 "Impairment of Assets" was issued in June 1998. This standard includes the requirement that the recoverable amount be estimated whenever there is an indication that the asset may be impaired, and that an impairment loss be recognised whenever the recoverable amount is less than the book value of the asset. The recoverable amount of an asset is the higher of its net selling price and its value in use, both calculated using the net present value method. The standard includes a list of indicators of impairment to be considered at each balance date.

- The international accounting standard IAS 38 "Intangible Assets" was issued in September 1998. This standard prohibits the recognition of assets such as internally generated goodwill, brands, mastheads, publishing titles and customer lists. This standard also requires that intangible assets can only be revalued if fair value can be determined by reference to an active market, and that an intangible asset must be amortised over the best estimate its useful life. An intangible asset cannot have an infinite useful life. If useful life is greater than 20 years, the intangible asset must be tested at least annually for impairment.

ASIC is of the view that it would be of great benefit to the marketplace if Australian accounting standards could be harmonised with IAS 36 and IAS 38 as soon as possible, to provide clear regulatory guidance in the Australian environment regarding accounting for the impairment of assets and for intangible assets.

10.4 ASIC is also of the view that it would be of great assistance to have available as soon as possible an accounting standard regarding the treatment of restructuring costs. In June 1996 the Urgent Issues Group (UIG) issued an abstract on this subject. The abstract includes the requirement that restructuring costs may only be recognised when, at acquisition, the entity is so committed to restructuring that payments cannot be avoided, and when the amount of the restructuring costs can be reliably estimated. While UIG consensus views are binding on members of the professional accounting bodies, they are not mandatory. The regulatory effect would be more widespread if an accounting standard were available.

11. CONCLUSIONS

11.1 ASIC's enquiry and investigation suggest that there were substantial problems in the herbs and spices businesses of Burns Philp well before the 1997 sales process and writedown. While the board recognised these problems in 1996, it appears that the action taken by company's directors was neither sufficient nor far-reaching enough to remedy the deficiencies. Earlier and clearer recognition of the problems might have allowed remedial steps to be taken which could have avoided the drastic action taken in September 1997.

The company has stated that it took the action appropriate to support the long term strategy, including expenditure to reduce costs and expand market share in the long run.

11.2 The impact of the problems was reflected in the share price. In mid 1995, Burns Philp shares were selling for $3.49. With the September release of the 1996 annual report the shares were trading at about $2.00. After the announcement of the proposed sale of the herbs and spices businesses in May 1997 the share price fell to $1.70. After the announcement that the herbs and spices businesses could not be sold, the share price fell to $0.18. While many factors influence share price, the falls relating to these specific events show substantial losses to shareholders.

11.3 This report has outlined a number of corporate governance practices of the board of Burns Philp which contributed to the problems experienced by the company. Some of the key corporate governance issues are:

- The need for adequate reporting by management to the board. Burns Philp had invested a significant proportion of its net worth in the herbs and spices strategy. Despite warnings from the auditor in relation to the 1995 and 1996 accounts, there was insufficiently rigorous testing of performance against budget for Burns Philp's herbs and spices businesses, and there was inadequate reporting of critical issues. This was compounded by the aggregations of data which meant that underlying problems in specific business areas were not apparent.

- The need to ensure that shareholders are properly informed about the strategies adopted by a company, the risks associated with those strategies and the results produced by those strategies. In this case, in the published financial statements there was no segmented reporting of the investments in and the results of the herbs and spices businesses.

- The difficulties that can arise with the appointment of chief executive officer as chairman. Previous strategies may not be properly reviewed and there can be a lack of independent leadership of the board.

- The use of optimistic accounting treatments, which can disguise the true performance of the business and delay remedial action.

11.4 Of particular concern to ASIC was the valuation of the herbs and spices assets, specifically the tradename values. As has been noted above, there appear to be grounds for questioning whether the tradenames could properly have been attributed the values reported in the June 1996 financial statements. The directors did recognise the sensitivity of the tradename valuations, obtaining three independent views. However this process was flawed by the failure to ensure the validity of information provided to the valuer and the reviewers, by the failure to check tradename valuations against net profit from tradename products for reasonableness, and by the failure to take account of all the assumptions in the valuation and review reports.

11.5 Although ASIC regards the above matters as serious, it has determined that it is not appropriate to commence legal proceedings in respect of the matters raised in this report.

11.6 The Corporations Law requires directors to "take all reasonable steps" to comply with (or secure compliance with) the provisions of the Law with respect to financial reports (section 344, previously section 318). The question of what "reasonable steps" are required will be a matter of fact, depending on the particular circumstances. As outlined above, ASIC believes that the steps taken by the directors arguably might not have been sufficient to constitute "reasonable steps". However, ASIC notes that a court would be likely to take into account the following matters:

- the fact that the directors had sought advice from three independent valuation experts.

- the fact that the auditors had signed off on the accounts.

- the complex and technical issues in involved in valuing intangible assets.

11.7 ASIC also considered the fact that, although it believes (as mentioned above) that the intangible assets may have been overstated in 1996, it is not straightforward to ascertain what a "correct" value would have been. In September 1997 the herbs and spices intangible assets were completely written off. However this occurred because a decision was made to write down the total value of the herbs and spices businesses to an amount equivalent to the highest purchase price offered for those businesses, not because the value of the intangible assets of the herbs and spices businesses had decreased to zero.

11.8 There is doubt as to whether, in all the circumstances of Burns Philp, a court would find that the directors failed to take all reasonable steps. Any such proceedings would be long and expensive. ASIC believes that a greater regulatory effect can be obtained through the publication of this report.

11.9 ASIC has also concluded that the commencement of legal proceedings is not justified in relation to any other party.

12. SUMMARY OF MATTERS RELEVANT TO THE MARKET

ASIC believes that the matters discussed above indicate a number of guidelines for all participants in Australian corporate life. These may be summarised as follows.

Directors are responsible to ensure that the board functions effectively

12.1 The chairman of the board in particular, and all the board members, are responsible to ensure that:

- the board works as an effective team.
- on a regular basis, the board critically reviews the effectiveness of business strategies and the effectiveness of senior management.
- progress is monitored and swift action is taken to remedy any deficiencies.

Directors are responsible to ensure they are appropriately informed about business performance

12.2 It is part of good corporate governance for directors to have up-to-date and reliable information about the performance of all components of the business. In particular, directors must:

- ensure that reports are prepared so that exceptionally good performance in some aspects of the business does not mask poor performance in other aspects of the business.
- ensure that reports provide sufficient information to explain the performance and position of new and high risk aspects of the business.
- be aware of practices such as aggressive accounting techniques and take action quickly and effectively to discourage the use of such practices. Company advisers may also play a role in alerting the board to this type of practice.

Directors must question and evaluate key features of intangible asset valuation reports

12.3 Directors cannot rely solely on the intangible asset values determined by independent experts. Nor can directors rely on employing a multiplicity of experts. The directors themselves must understand what the valuers are saying. As a first step, directors must require valuation reports to be prepared so that assumptions are clearly disclosed and comprehensible.

12.4 The directors must then:

- consider whether the assumptions used by the valuers are reasonable, in the light of the directors' overall knowledge of the business.
- consider the reliability of the source data used by the expert valuers.
- undertake reasonableness checks of the values ascribed to the intangible assets by the expert valuers.

12.5 If, after considering the valuations derived by the experts, the directors have any queries about the intangible asset valuations, the directors are responsible to raise these concerns with the expert valuers and ensure that they are satisfactorily resolved.

Directors are responsible to ensure that shareholders are appropriately informed

12.6 In fulfilling their corporate governance responsibilites, directors must ensure that reliable information is provided in a timely manner to shareholders regarding:

- the overall business strategies adopted by the company, and the timeframes in which it is anticipated that the benefits of these strategies will be obtained.
- the risks associated with those strategies.
- the performance and position of the company resulting from those strategies

Auditors must question and evaluate material intangible asset valuations

12.7 For material and high risk accounts it is not sufficient for an auditor to rely on the conclusions drawn by an expert employed by the company. Nor is it sufficient for an auditor to rely on an expert employed by the company to report on the work of another expert employed by the company.

12.8 In particular, Auditing Standard AUS 606 "Using the Work of an Expert" requires that auditors:

- determine whether an expert has used source data which is sufficient, relevant and reliable.

- obtain an understanding of the assumptions and methods used by the expert.

- consider the results of the expert's work in the light of the auditor's overall knowledge of the business and the results of other audit procedures.