



ASIC

Australian Securities & Investments Commission

REPORT 234

Response to submissions on CP 143 Expert reports and independence of experts

March 2011

About this report

This report highlights the key issues that arose out of the submissions received on Consultation Paper 143 *Expert reports and independence of experts: Updates to RG 111 and RG 112 (CP 143)* and details our responses in relation to those issues.

About ASIC regulatory documents

In administering legislation ASIC issues the following types of regulatory documents.

Consultation papers: seek feedback from stakeholders on matters ASIC is considering, such as proposed relief or proposed regulatory guidance.

Regulatory guides: give guidance to regulated entities by:

- explaining when and how ASIC will exercise specific powers under legislation (primarily the Corporations Act)
- explaining how ASIC interprets the law
- describing the principles underlying ASIC's approach
- giving practical guidance (e.g. describing the steps of a process such as applying for a licence or giving practical examples of how regulated entities may decide to meet their obligations).

Information sheets: provide concise guidance on a specific process or compliance issue or an overview of detailed guidance.

Reports: describe ASIC compliance or relief activity or the results of a research project.

Disclaimer

This report does not constitute legal advice. We encourage you to seek your own professional advice to find out how the Corporations Act and other applicable laws apply to you, as it is your responsibility to determine your obligations.

This report does not contain ASIC policy. Please see Regulatory Guide 111 *Content of expert reports* (RG 111) and Regulatory Guide 112 *Independence of experts* (RG 112).

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A Overview/Consultation process

- 1 In Consultation Paper 143 *Expert reports and independence of experts: Updates to RG 111 and RG 112* (CP 143), we consulted on proposals to address compliance issues identified during a detailed review of the independent expert sector. We also consulted on other updates to Regulatory Guide 111 *Content of expert reports* (RG 111) and Regulatory Guide 112 *Independence of experts* (RG 112) as a result of a more general review of those policies.
- 2 Generally, the proposals were designed to provide additional guidance on the obligations of experts and commissioning parties when preparing expert reports.
- 3 The proposals sought to provide further guidance on the content of expert reports, including the following:
 - (a) the analysis of whether a transaction is fair and reasonable;
 - (b) the valuation requirements for demergers;
 - (c) an expert's choice of methodology;
 - (d) the requirement that an expert's opinion be based on reasonable grounds;
 - (e) the use of the discounted cash flow valuation methodology to value development assets;
 - (f) the obligations of a commissioning party when there is a change in circumstances; and
 - (g) ASIC's expectations for the preparation of expert reports and for an expert's working papers.
- 4 The proposals also sought to provide additional guidance on the independence of experts to help experts and commissioning parties. The proposed guidance dealt with:
 - (a) the disclosure of relationships and interests;
 - (b) commissioning an expert;
 - (c) the release of an expert's conclusions ahead of the final report; and
 - (d) using a specialist report.
- 5 This report highlights the key issues that arose out of the submissions received to CP 143 and our responses to those issues.
- 6 This report is not meant to be a comprehensive summary of all responses received. It is also not meant to be a detailed report on every question from CP 143. We have limited this report to the key issues.

Responses to consultation

- 7 We received 12 responses to CP 143 from a wide variety of sources, including relevant industry bodies and industry participants. We are grateful to respondents for taking the time to send us their comments.
- 8 For a list of the non-confidential respondents to CP 143, see the Appendix. Copies of the non-confidential submissions are on the ASIC website at www.asic.gov.au/cp under CP 143.
- 9 There was general support for the majority of the proposals in CP 143, with respondents raising matters of detail on some proposals.
- 10 In light of submissions, we have not adopted our original proposal on the use of the discounted cash flow (DCF) methodology. We have instead clarified that the DCF methodology can be used before a project generates cash flows as long as the expert has reasonable grounds for the forward-looking information. The expert must also disclose how the development stage risks have been reflected in the DCF methodology.
- 11 We have decided to implement most of our other proposals, although not on the exact terms proposed in CP 143 in all cases. For more detail, see the remainder of this report.

B Proposed revisions to RG 111

Key points

CP 143 contained proposals to update our guidance in RG 111 on the content of expert reports in several areas.

We have updated RG 111 largely as proposed, with some minor amendments based on respondents' submissions.

We have not adopted our original proposal on the use of the DCF methodology, but have provided some additional guidance.

Analysing whether a transaction is fair and reasonable

- 12 In CP 143, we proposed clarifying in RG 111 that:
- (a) fairness should be determined assuming a knowledgeable and willing, but not anxious, buyer and a knowledgeable and willing, but not anxious, seller acting at arm's length;
 - (b) synergies that are only available to a particular bidder should not be taken into account when determining fairness;
 - (c) in the case of a transaction that is 'not fair', where reasonably practicable, an expert should value reasonableness factors;
 - (d) an example of a situation where a bidder may offer a price that is 'not fair' is where a target is in financial distress. Such an offer may nonetheless be reasonable if the alternative methods of remedying the financial distress are likely to be less attractive to security holders than a successful offer.
- 13 The majority of submissions were generally in favour of our proposals.
- 14 There was general agreement on proposals to clarify the determination of fairness and the availability of synergies to a particular bidder, with respondents noting that these proposals were consistent with market practice.
- 15 Respondents were generally in favour of the proposal that an expert should value reasonableness factors where a transaction was 'not fair', although submissions noted that this may be impractical in some cases and that there may be difficulty in performing such valuations with sufficient precision. Respondents also noted that it would be helpful to experts for ASIC to provide further examples of the types of reasonableness factors that should be valued or quantified. We also received feedback that it would be more appropriate for the guidance to require reasonableness factors to be quantified rather than valued.

- 16 In relation to the proposal outlined in paragraph 12(d) on a target in financial distress, one respondent noted that the requirement to ignore the need for an urgent capital raising when assessing the fairness of a transaction is inconsistent with what a willing, but not anxious, buyer and seller would do. The respondent went on to say that this view of fairness, which requires commercial realities to be ignored, forces experts to value shares at values which are out of line with the trading prices of listed securities.
- 17 After we released our consultation paper, the Takeovers Panel noted in *Northern Energy Corporation Limited* [2011] ATP 2 that to the extent the issue needs clarification, our current review of RG 111 would be a useful vehicle to clarify that, when valuing a company, RG 111 does not require an expert to assume that the company has the financial capacity to meet its funding requirements.

ASIC's response

We have adopted all of our proposals with some minor amendments based on respondents' submissions.

We have adopted the suggestion that we should require reasonableness factors to be 'quantified' rather than 'valued'. This will allow experts to provide quantitative information on reasonableness factors, such as the liquidity of the market in the target's securities, without necessarily having to attribute a 'value' to the factor. The updated RG 111 provides that experts should quantify reasonableness factors only where this can be done with sufficient precision to assist security holders: see RG 111.17.

We have provided some examples of reasonableness factors that can be quantified.

We have retained the example of a target in financial distress as a situation where the bidder may offer a price that is not fair, but reasonable. We think that the determination of fairness on the basis of a not anxious seller in this case should assist target shareholders by identifying the extent to which the price being offered may be less than the value of the underlying assets in an orderly realisation. We have noted at RG 111.15 that the reason that an offer price may be 'not fair' in this situation is because of the requirement in the fairness test to value the target's securities on the basis of willing, but not anxious parties. The price offered may nonetheless be reasonable given the available alternatives.

For the avoidance of doubt, we have clarified that the funding requirements of a target that is not in financial distress (e.g. capital that is required to develop a project) should generally be taken into account when determining the fair value of target securities.

Valuations and demergers

- 18 In CP 143, we proposed that if an expert analyses a demerger on the basis of whether the advantages outweigh the disadvantages, where reasonably practicable, the expert should generally value the advantages and disadvantages that it considers to be material.
- 19 We also sought comments on whether, where an expert does not value the demerged businesses in a demerger, the expert should be required to:
- (a) explain why the demerger does not give rise to a material change to the overall value of the demerged businesses; or
 - (b) if there is a material change to the overall value following the demerger, quantify this change.
- 20 There was support at a general level for our proposal, with respondents nonetheless keen to ensure that ASIC recognised the difficulties inherent in valuing the advantages and disadvantages of demergers. Similar to the valuation of reasonableness factors, respondents again emphasised the difficulty in precisely valuing these factors. Some respondents submitted that our guidance should not overemphasise the importance of valuing advantages and disadvantages in a demerger. We also received feedback that it would be more appropriate for the guidance to require advantages and disadvantages to be quantified rather than valued.
- 21 Respondents were less supportive of requiring experts to explain whether a demerger would result in a material change to the overall value of the demerged businesses. Submissions stated that it was important for experts to be able to recommend demergers based on an evaluation of qualitative factors.

ASIC's response

As for the assessment of reasonableness factors, we have required the advantages and disadvantages of demergers to be quantified where this can be done with sufficient precision.

Based on submissions received, we have not required experts to either explain why the demerger does not give rise to a material change to the overall value of the demerged businesses, or quantify the extent of that change.

Choice of methodology

- 22 In CP 143, we proposed that:
- (a) if an expert's valuation of a company differs materially from the company's share price in the period leading up to the announcement of the proposed transaction (plus a typical premium for control for such a

transaction), the expert should comment on this difference and the factors underlying it; and

- (b) where an expert uses more than one valuation methodology, the expert should comment on the relative weight being placed on each methodology.

- 23 Respondents generally supported the proposal to require experts to comment on a material difference between their valuation and the company's share price in the period leading up to the announcement of the proposed transaction. It was noted that the majority of expert reports will generally comment on a listed company's share price, and that the price of listed securities is a relevant data point in assessing the fair market value of a security.
- 24 Submissions were generally not in favour of ASIC adopting a specific percentage difference for the purposes of defining a 'material difference', with respondents considering that we should not be overly prescriptive in this area.
- 25 Submissions noted that it may be appropriate for ASIC to clarify that it is generally appropriate for an expert to use a primary methodology in valuing a company, with other methodologies being used to support the resulting value. A number of submissions were not in favour of experts being required to ascribe percentage weightings to each methodology used.

ASIC's response

Share price materially different

We have adopted our proposals regarding differences between an expert's valuation and the company's recent share price. We agree with submissions that it will generally be appropriate for an expert to comment on a listed company's share price and have included a cross-reference to RG 111.69, which states that it is generally appropriate for an expert to consider the quoted price for an entity's listed securities as a valuation methodology: see RG 111.65.

Based on submissions received, we have not specified a particular percentage in defining what constitutes a 'material difference' in this context.

We have seen transactions where the expert's valuation is less than the company's share price in the period leading up to the announcement of the transaction. The updated RG 111 notes that, in these circumstances, we expect the expert report to contain a discussion on the reasons for this: see RG 111.65.

Weighting of methodologies

As identified in the draft version of RG 111 that we consulted on, we think it is sufficient for an expert to identify which methodology is the primary methodology and which are the secondary methodologies. We have not required an expert to ascribe percentage weightings to methodologies.

Expert's opinion to be based on reasonable grounds

- 26 RG 111.77 previously stated that:
- An expert should conduct such critical analysis of the information on which it relied to prepare the report as is reasonable in the circumstances and as the law requires: *Australian Co-operative Foods* at 77. The more material the information is to the conclusions reached by the expert, the greater the responsibility on the expert to be satisfied that the information is not materially inaccurate. If there are indications suggesting that the information in question may not be reasonably relied on, then the expert should make additional enquiries. We do not expect an expert to conduct an audit of the subject matter of the report. If an expert cannot satisfy itself that it is reasonable to rely on otherwise material information, it should say this in its report with an explanation. In some circumstances, an expert may need to consider not relying on such information.
- 27 In CP 143, we proposed to delete the last two sentences of this paragraph to clarify our expectations about information relied on by the expert.
- 28 A number of submissions supported the deletion of the relevant sentences, with respondents noting that the sentences are redundant and that the change would remove ambiguity about relying on information by an expert.
- 29 Those respondents who thought the sentences should be retained suggested that the guidance be amended to reflect that an expert should only be entitled to rely on these sentences in exceptional circumstances.

ASIC's response

As originally proposed, we have deleted the relevant sentences. We note that, with the sentences deleted, our guidance requires an expert to undertake such critical analysis of information as is reasonable in the circumstances and as the law requires. If circumstances are unusual or exceptional, an expert will need to demonstrate that they have undertaken the necessary analysis of the relevant information given those circumstances.

An expert may also need to consider refusing a report if it does not have sufficient information or enough time to prepare the report: see RG 111.108 and RG 111.109. We consider that these settings are appropriate. We were concerned that retaining the sentences might suggest that an expert could rely on material information in the absence of a reasonable basis.

Use of the DCF methodology

- 30 In CP 143, we proposed that a start-up or potential development asset should only be valued using the discounted cash flow (DCF) methodology when there is a reasonable basis to conclude that the proposed development will proceed.
- 31 We also sought submissions on whether it is reasonable to apply the DCF methodology to mineral and hydrocarbon potential developments that are

classified lower than a reserve category under the Australasian Code for Reporting of Exploration Results, Mineral Resources and Ore Reserves (JORC Code) or the Petroleum Resources Management System (PRMS).

- 32 Submissions were generally not supportive of specific limitations being placed on the use of the DCF methodology. We received submissions that:
- (a) the DCF methodology is the most common and well-regarded valuation technique in the mining industry;
 - (b) the DCF methodology can deal with uncertainty through adjustments to discount rates and cash flows;
 - (c) other valuation methodologies are less reliable; and
 - (d) only being able to include mineral and hydrocarbon reserves in the DCF analysis could lead to overly conservative valuations.

ASIC's response

In view of the submissions received, we have not included a requirement that the DCF methodology should generally only be used for assets above a particular level of development. We have recognised that the DCF methodology may be used before a project generates cash flows as long as the expert has reasonable grounds for the forward-looking information used in the methodology.

While an expert may choose to use the DCF methodology for early stage development assets, we have included guidance that the expert must disclose the extent and nature of the adjustments made to the methodology to allow for the development stage risks attaching to these cash flows.

We will continue to monitor the use of the DCF methodology in valuations and consider whether further guidance is necessary.

Change in circumstances

- 33 In CP 143, we proposed clarifying that a commissioning party should notify the expert if the commissioning party becomes aware of a significant change affecting the information in the expert report before a meeting being held or during the offer period.
- 34 There was unanimous support for this change. Respondents noted that it was consistent with the requirement that the commissioning party make all relevant information available to the expert and the expert issue a supplementary report if there is a material change in circumstances.

ASIC's response

We have made this change on the terms set out in CP 143.

Expectations for report preparation

- 35 In CP 143, we invited comments on our proposal that security holders would generally expect an expert to have made all appropriate inquiries to prepare the report, that the report will not omit any matter that the expert considers to be material to security holders' assessment of the expert's conclusions, and that the report will have been prepared in accordance with normally applicable standards and guidelines.
- 36 We also invited comments on a related proposal that if a report has not been prepared on the basis described in paragraph 35, the report should prominently explain the reasons for this and the impact of this on the report. If a report cannot be prepared on such a basis, the expert may need to consider whether it should refuse to give the report.
- 37 Finally, we sought feedback on whether there should be a positive obligation on an expert to include a statement in its report:
- (a) confirming that the report has been prepared on the basis described in paragraph 35; or
 - (b) identifying the reasons why the expert is not able to provide such a confirmation.
- 38 Most respondents were in favour of our proposals. Some respondents commented that we should provide further guidance on what constitutes normally applicable standards and guidelines.
- 39 Most respondents who expressed a view agreed that there should be an obligation on an expert to include a positive statement in its report, provided that 'normally applicable standards and guidelines' was defined. We also received feedback that a positive statement was not necessary.

ASIC's response

We have amended RG 111 to provide that security holders would generally expect that:

- an expert has made all appropriate inquiries to prepare the report; and
- the report has not omitted any matter that the expert considers to be material to security holders' assessment of the expert's conclusions.

In relation to preparing a report in accordance with 'normally applicable standards and guidelines', we have included the following note to RG 111.114:

Note: To the extent that there are any normally applicable standards and guidelines for valuing a particular class of assets (e.g. the Valmin Code for valuations involving mineral and hydrocarbon assets), security holders will generally expect that these have been complied with. The report should disclose if that is not the case as that will be a matter that is relevant to security holders' assessment of the expert's conclusions.

ASIC's response (cont.)

Other than the Valmin Code, the feedback received did not identify standards and guidelines that would generally apply to particular asset classes. We have therefore not required a positive statement that normally applicable standards and guidelines have been complied with. Nonetheless, to the extent that there are such standards (e.g. the Valmin Code), security holders would generally expect that these have been complied with. The note will also be useful to the extent that generally applicable standards and guidelines may develop over time.

Although the note relates to standards that are relevant to valuing particular classes of assets, we also expect an expert to comply with any professional standards that apply to the expert.

Working papers

- 40 In CP 143, we invited comments on our proposal that an expert should document its work and maintain adequate working papers that record the basis of the expert report. We also invited comments on our proposal that where an expert has relied on a financial model as part of its valuation, the expert should review the operations of this model and record the results of this review in its working papers.
- 41 Finally, we sought feedback on whether we should provide further guidance on the extent to which a financial model should be reviewed or whether the wide range of potential financial models meant that it is not practical to provide more detailed guidance.
- 42 Most respondents were in favour of these proposals.
- 43 In relation to documentation of working papers, while agreeing with the proposal, a number of respondents commented that we should recognise that unlike an audit, a large portion of an expert's analysis, including reasoning and methodology, will be fully documented in its report.
- 44 One respondent stated that the requirement to review a financial model should not be interpreted as meaning that an audit is required.
- 45 Most respondents considered that it was not practical to provide more detailed guidance on the extent to which a financial model should be reviewed due to the wide range of potential models.

ASIC's response

We have adopted our proposals broadly as proposed.

We consider that documenting its work and maintaining adequate working papers will assist an expert demonstrate that it has acted independently and has reasonable grounds for its opinion. We agree that much of the expert's analysis will be described in its report.

ASIC's response (cont.)

However, it will still be important for an expert to document and maintain adequate working papers. The requirement to document adequate working papers does not detract from the obligations of an expert with respect to the contents of an expert report.

We consider that an expert should review a financial model and document its analysis because this will assist the expert demonstrate that it has reasonable grounds to rely on the model. We have clarified that we do not expect an expert to conduct an audit of a financial model.

We have not provided further guidance on the extent to which a financial model should be reviewed due to the wide range of potential financial models.

C Proposed revisions to RG 112

Key points

CP 143 contained proposals to update our guidance in RG 112 on the independence of experts in several areas.

We have updated RG 112 largely as proposed, with some minor amendments based on respondents' submissions.

Disclosure of relationships and interests

- 46 In CP 143, we invited comments on our proposal that if, within the previous two years, an expert has valued an asset representing at least 30% (by value) of the assets that it is valuing for the commissioning party, this should be prominently disclosed in its report.
- 47 Most respondents were in favour of disclosing previous valuations undertaken by the expert. However, a number of respondents stated that previous engagements should not be perceived as conflicting with future valuations or the ability of an expert to provide an unbiased independent opinion. Two respondents commented that although previous engagements should be disclosed by the expert, it was not necessary for the disclosure to be prominent.
- 48 A number of respondents stated that there was no good basis for selecting 30%, or any other fixed percentage, as the threshold for disclosure. One respondent commented that an expert who has previously valued any percentage of the commissioning party's assets should disclose this previous engagement. Another respondent considered that it would be relevant for security holders to know if the expert had previously valued a material portion of the assets.

ASIC's response

We have replaced the proposed 30% threshold with a requirement to disclose if the previously valued assets represent more than a *de minimus* (i.e. trivial) proportion of the assets being valued. We agree that it will generally be relevant for experts to disclose in their report if they have previously valued more than a trivial proportion of the assets currently being valued.

We note that RG 112 also imposes a requirement for experts to disclose if the commissioning party or an associate has previously engaged the expert to undertake any valuation work: see RG 112.31 and RG 112.32.

ASIC's response (cont.)

A number of submissions commented that where an expert has previously valued a proportion of the assets, this should not be perceived as affecting the ability of the expert to provide an unbiased independent opinion. Although this previous work will not necessarily affect the ability of an expert to provide an independent valuation, it will nonetheless be a relevant matter to disclose to shareholders.

We have included a requirement that disclosure be prominent. This is consistent with the level of disclosure required for other relevant information about the expert: see RG 112.31. In any event, we expect that it will usually be the case that the expert will not have previously valued the relevant assets. If so, no disclosure would be required.

Commissioning an expert

- 49 In CP 143, we invited comments on our proposal that before engaging an expert, a commissioning party should consider certain factors relating to the independence of the expert and the expertise and resources of the expert.
- 50 We also invited comments on our proposal that a commissioning party should ensure that the method by which an expert is appointed is consistent with the concepts of independence and perceived independence of the expert.
- 51 The majority of respondents were in favour of these proposals. However, two respondents commented that when assessing whether an expert has the requisite expertise and resources to assess a transaction, whether the expert has already provided an opinion on a similar transaction does not, of itself, attest to the expert's competency.

ASIC's response

We have adopted the proposals in CP 143 on independence.

We agree that the fact that an expert has given an opinion on comparable transactions does not, of itself, attest to the expert's competency. Nonetheless, we think it is a factor that will generally be relevant (together with other factors) to the expert's experience and competency.

Release of an expert's conclusions ahead of the final report

- 52 In CP 143, we invited comments on our proposal to provide guidance that a commissioning party should generally not release an expert's conclusions in advance of the final report.
- 53 A strong majority of respondents agreed with this proposal.

ASIC's response

We have adopted this proposal.

Use of a specialist report

- 54 RG 112.73 states that where a specialist does not take responsibility for or authorise the use of its report and the expert considers that the material the subject of the report needs to be included in the expert's report, the expert must accept entire responsibility for the statements as the expert's own and have reasonable grounds for believing the statements not to be misleading or deceptive.
- 55 We consulted on whether we should provide guidance on the factors that may be relevant to whether an expert has reasonable grounds for believing that a specialist's statements are not misleading or deceptive
- 56 Most respondents did not believe that guidance was necessary. A number of respondents commented that a specialist will generally be engaged by an expert on the basis that the specialist will take responsibility for its report and authorise its use by the expert. Some respondents stated that where an expert intends to rely on or use the specialist report without the specialist's consent, RG 112.71(a) adequately sets out the relevant considerations to determine whether the expert has reasonable grounds for believing that the specialist's statements are not misleading or deceptive.
- 57 One respondent stated that where an expert intends to rely on a specialist report in the circumstances described, then either the report should not be material, or the expert should have the appropriate skill to form its own view.

ASIC's response

We have not provided further guidance in light of the fact that most respondents did not generally believe that additional guidance was necessary.

We agree that a specialist will generally be engaged by an expert on the basis that the specialist will take responsibility for its report and authorise its use by the expert. Ensuring the specialist is engaged on this basis will mean that the expert does not need to accept entire responsibility for the statements in the specialist report as the expert's own.

Appendix: List of non-confidential respondents

- Ms Felicity Agsten
 - Deloitte Corporate Finance Pty Ltd
 - Ernst & Young
 - Grant Samuel & Associates Pty Ltd
 - Institute of Chartered Accountants in Australia
 - KPMG Corporate Finance (Aust) Pty Ltd
 - Lonergan Edwards & Associates Limited
 - Protavia
 - PricewaterhouseCoopers Securities Ltd
 - The Australian Property Institute
 - Dr Andrew H White
-