ARE INDEPENDENT EXPERTS WORTH THE COST?

The ASC persists with its requirement for independent expert reports in some takeover situations, despite the fact that most IERs rely on valuation techniques known to be inadequate.

Z.P. MATOLCSY canvasses the shortcomings of IERs and suggests that if we must have them, some new rules should apply.

Z.P. Matolcsy is professor of accounting at the University of Technology, Sydney.

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It was argued a decade ago by Matolcsy (1982) that Section 23 of the old Companies (Acquisition of Shares) Act 1981, which calls for independent expert reports (IERs) to advise whether a takeover offer is fair and reasonable, has been an unnecessary regulation of economic activity. The reasoning was based on the argument that within the conceptual framework of efficient markets, independent expert valuers would have to value offers at the market price of the day.

The rest is corporate history. The National Companies and Securities Commission (NCSC) not only retained s.23, but issued a number of policy statements and revisions of these statements to provide direction and to refine, among other things, the appropriate method of valuation.

The Australian Securities Commission’s (ASC) Policy Statement 43, issued on 8 December 1993, confirmed the spirit of the previous policy statements issued by the NCSC. Despite these efforts, and more than ten years of experience with IERs, there is no empirical evidence which would demonstrate the benefits of such reports. In fact, a number of legal cases and considerations raise serious doubts about the usefulness of IERs.

Further, there is an illusion, created by the regulators, that a single outside person, the independent expert valuer, could value an entity more accurately than all other investment analysts, credit-rating agencies, broking houses and financial experts who publicly express their valuation of the entity through the market price.

For an independent expert report to add value, at least two conditions have to be met:

• the independent expert must identify additional, “private” information which is not available to the market; and

• the independent expert must adopt a valuation technique which is technically correct and enables him or her to identify the synergistic benefits of the takeover.

This paper will not address the first condition, although the following two observations may be insightful. First, Fama (1991) reviews the past 20 years or so of accounting and finance research by hundreds, if not thousands, of researchers all around the world and concludes: “The efficiency research put forth the challenge that private information is rare.”

Second, the share price of a company is set by the last investor who traded in that share. Accordingly, as long as any one of the investors has the same information as the independent expert, it would already be reflected in the share price. It is highly unlikely that a company would have substantial new private information which would not have been disclosed to financial analysts of rating agencies, brokers and institutional investors.

This paper addresses the second necessary condition of value adding by IERs. Specifically, the objective of the study is threefold:

• to provide some descriptive evidence on who are the key providers of IERs and what valuation methods they use;

• to highlight some of the technical difficulties associated with the current popular valuation methods adopted in IERs, and the inability of these methods to identify the synergistic benefits of takeovers, and to question the value added by these reports; and

• to provide some future policy prescriptions for the ASC to enhance the value added of IERs.
Obviously, the evidence and the arguments of this paper are based on the "average" IER; in fact, reports vary greatly in length and quality. Accordingly, not all comments refer to all providers of IERs.

THE PROVIDERS OF IERS
Eddy (1993) provides some evidence on the pricing and the recommendations of the experts. However, to gain an insight into the background of the providers of expert reports and their method of valuation, data has been obtained from the database of Corporate Adviser Pty Ltd for all takeovers in the period 1988-93.

Table 1 lists the top three providers of independent expert reports on a year-by-year basis.

The overall results in Table 1 indicate that there were seven "top" providers of IERs, almost exclusively representing independent expert reports, four broad classifications have been developed:

- asset-based valuation methods;
- capitalised earnings methods;
- discounted cashflow methods; and
- other techniques such as historical review of market price, resource-in-the-ground method or a combination of assets and earnings-based methods.

They key results of these classifications are summarised in Table 2. The results in Table 2 indicate that asset-based valuation methods are the technique most frequently concluded-on (31.14%), followed by variations of the earnings capitalisation method (26.90%). The high percentage of "other" techniques results from the relatively high percentage of sample companies (34.78%) from the mining and mineral exploration industry classification.

The most interesting feature of these results is that the discounted cashflow (DCF) method is the least-used method, representing just 8.38% of all valuations. Further, had one of the accounting firms which consistently used this method been omitted, then the discounted cashflow method would have been used in less than 4 per cent of all valuations.

The discounted cashflow model has been mainly used for non-industrial companies, as indicated in Table 3.

Table 3 reinforces the point made previously and provides further evidence for industrial companies that independent experts, with the exception of one accounting firm, do not use DCF valuation methods in their IERs.

The evidence in Table 2 also clearly indicates the influence of NCSC and ASC policy statements on the choice of methodologies adopted by independent experts, although these policy statements are not binding.

In fact, they explicitly state that the guideline is "without limiting the expert's exercise of skills and judgment forming his or her opinion in selecting the most appropriate method of valuation".

Perhaps the only plausible explanation for the selection of asset-based and capitalised earnings methods, despite their shortcomings, is that independent experts felt "legally safe" with these methods following Issue No. 3 of Policy Statement 102.

The significant impact of the policy guidelines on the choice of valuation methods reinforces the need to examine the validity of the most popular valua-
tion methods and to reconsider future guidelines by the ASC.

TECHNICAL DIFFICULTIES WITH VALUATION METHODS

As indicated in Table 2, the two most popular valuation methods were variations of the asset-backing method and the capitalised earnings method.

Asset-backing-based valuation method

The essence of this method is to identify and list the reported book values of assets and liabilities, make an adjustment for intangible assets and estimate the net assets as the difference between these two items.

Independent experts occasionally may adjust some items to overcome the well documented shortcomings of historical cost accounting reporting methods - but even with these adjustments the resultant valuation is meaningless because historical values of assets have very little to do with realisable values, replacement costs or current costs. Equally, "book values" of liabilities do not reflect the current market values of those liabilities.

Even with access to internal accounts (such as asset registers, aging of the debtors and details of the debt structure), the independent experts do not often revalue all assets and liabilities. In the sample of this study, only one IER has done so.

Alternatively, independent experts could use externally and independently adoptable methods of restating historical cost accounting reports to reflect more up-to-date values of assets and liabilities although the accuracy of these methods is debatable and has not been adopted in IERs.

Some of the difficulties associated with the asset-backing-based valuation methods are illustrated by the debate on Exposure Draft 49 Accounting for Identifiable Intangible Assets and the debate on the valuation of non-current assets.

ED49 aimed to address the difficulties associated with valuing identifiable intangible assets, such as mastheads, television licences and trademarks.

Table 3: Utilisation of DCF techniques by industry classifications

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<td>Industrial companies</td>
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<td>3</td>
<td>4</td>
<td>4</td>
<td>2</td>
<td>1</td>
<td>16</td>
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<tr>
<td>Mining companies</td>
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<td>10</td>
<td>8</td>
<td>3</td>
<td>7</td>
<td>74</td>
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<tr>
<td>Total</td>
<td>32</td>
<td>16</td>
<td>14</td>
<td>12</td>
<td>5</td>
<td>8</td>
<td>87</td>
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However, recently the Australian Accounting Standards Board has withdrawn the exposure draft because the accounting profession could not achieve consensus on its content.

On the other hand, since 1 July 1992 Section 294 (4) of the Corporations Law has required directors to take reasonable steps to establish whether the book value of the non-current assets exceeds the amount "that it would have been reasonable for the company to expend to acquire the asset".

However, this requirement has a number of conceptual and practical difficulties.

Even if these conceptual and practical difficulties were to be eliminated on the asset side of the balance sheet, the value added by the net asset valuation would have to be questioned.

Further, and perhaps most importantly, the technique itself does not enable the independent expert to identify the synergistic benefit of a takeover on the revenue and/or expenses side, as it is a balance-sheet-based valuation method.

Capitalised earnings method

The essence of this valuation method is to estimate "maintainable" future earnings and then use an appropriate multiplier (or divide by the reciprocal of the multiplier). Generally, the multiplier is based on the observed historical price-earnings (P/E) ratios of "comparable" companies or the average of the appropriate industry provided by some statistical service such as the Sydney Stock Exchange's Statex service.

The theoretical foundation of this approach is well established in the finance literature. It is based on a version of the dividend valuation model, which assumes constant growth of dividends to infinity and no additional external financing. Under this assumption the value of equity is equal to the future maintainable earnings of a company multiplied by a multiplier, which in turn is a function of the dividend policy of the firm, the shareholders' required rate of return and the expected growth rate of dividends.

However, there are a number of problems with the current practice of applying this method. When the independent expert estimates the maintainable earnings, the underlying implicit assumption is that all other experts and investment analysts in the market have not estimated the maintainable earnings correctly. Hence the current market price does not reflect the true value of the target company's equity. In other words, the market is inefficient with respect to that single company.

In contrast, when the multiplier is approximated by observed historical price/earnings ratios for comparable companies or industries, the implicit assumption is that the market is efficient and that experts and investment analysts can correctly estimate the maintainable earnings and therefore the value of all other companies. Further, when historical price/earnings ratios are observed, it is implied that the best estimate of future earnings is the last available earnings.
Otherwise, independent experts would construct and use price/earnings ratios based on predicted earnings for comparable companies and industries.

The independent experts cannot have it both ways. If the market is assumed to be efficient with respect to all companies, the best estimation of value is the current market price.

On the other hand, if the market is assumed to be inefficient, then all components of the capitalised earnings model need to be explicitly re-estimated. However, even under this second approach, it is difficult to see how the impact of alternative financing packages on the value of a target company can be evaluated at a practical level.

Finally, it is not likely that all the benefits of a takeover would be realised within one year. Hence, the single profit estimate does not enable or force the expert to communicate the effects of a takeover on the revenue and cost estimates over time.

In summary, neither the asset-backing method nor the capitalised earnings method is likely to add value for shareholders, because the techniques are fraught with conceptual difficulties. More important, they cannot explicitly accommodate the synergistic benefits of a takeover.

The DCF method, however, would add value because:

- academics and practitioners increasingly believe that conceptually the discounted cashflow method is the appropriate valuation method; 
- these valuation methods have the potential of overcoming all the technical difficulties associated with other methods as discussed previously; and
- the earnings multiplier method is a special example of the discounted cashflow method.

Perhaps the most compelling argument for the DCF method is that independent experts could specifically identify the revenue and/or cost items where the synergistic benefits would be generated by the offeror companies.

**POLICY RECOMMENDATIONS**

It has been argued in this paper that independent expert reports are not likely to add value because the valuation techniques are highly questionable. This conclusion is disturbing, given that one of the main providers of IERs, the chartered accounting firms, have, in another arena, been critical of the shortcomings of historical cost accounting procedures and vigorous in promoting new accounting procedures and standards to overcome these shortcomings.5

Perhaps it could be argued that they were following the letter of the various NCSC and ASC practice notes, which recommended valuation methods, rather than the spirit of the entire Companies (Acquisition of Shares) Act 1981, which required them to provide useful information to investors. Either way, there is very little to be gained in apportioning blame for a questionable past practice. However, there is much to be learned from the lessons of the past in formulating future policies.

One of the policy implications of this study is that the Australian Securities Commission should provide some empirical evidence on the benefit of IERs. For example, the Commission could evaluate the price impact of the release of independent expert reports or survey shareholders about their usefulness. However, the ASC has no economic incentive to provide such evidence and is unlikely to do so.

If the ASC decides to continue to require IERs, even though their value is highly questionable, then it should at least consider the following policy recommendations for inclusion in a future practice note. These recommendations not only overcome the technical difficulties of the current methods applied in IERs, but have the potential to add value for shareholders.

First, each IER should include an estimate based on the “current market” price plus the historical premiums paid in takeovers.13 Such a valuation method would be based on actual observations and would add value by providing an objective yardstick for value.

Second, the recommended method of valuation should always be based on discounted cashflow methods and experts should have to justify the use of any other techniques.

Third, the ASC should continue with the requirement that independent valuers are to seek out additional, non-publicly available information on the company to enhance their valuation. Further, they should be required to include this additional “inside” information in a separate section of the IER. This would add value by providing a useful check-list to other participants in the market.

Fourth, the ASC should not establish a register of independent experts to control the quality of IERs, hence the value added by experts. Rather, they should simply regulate so that experts receive their fees in the form of shares in the companies they have valued. They could be paid at the rate of their own valuation or the offer price, which ever is higher.14 If this condition applied, the experts would not be penalised for “low” valuations but they would be backing up any “high” valuations with their own money. The market will then sort out the real experts from the great pretenders.

**NOTES**

1 For a review of the different rules and NCSC policy statements on this issue, see Lonergan (1991).
2 See, for example, the negligence case filed against Ernst & Young with respect to their IERs on the reverse takeover of Duke by Kia Ora Gold, or the ASC examination of the IER on Ramsey Health Care Ltd, reported by the Australian Financial Review on 6 April 1992.
3 An independent expert report is not required in every instance, only when (i) the offeror is entitled to at least 30
per cent holdings, (ii) there are two or more classes of voting shares or (iii) the offeror is a director of the target company or at least one director is a director of both the offeror and the target company.

4 I thank W. Lonergan for drawing my attention to the rating of IERs by the Corporate Adviser.

5 See page 6 of Draft Practice Notice: Company or Asset Valuation Reports, issued by the ASC on 23 December 1992.

6 For one of these methods, see Matolcsy (1984).

7 For some of the conceptual difficulties, see Henderson and Goodwin (1992) whilst Arthur Andersen’s FINAC (July 1992), among others, summarises some of the practical difficulties associated with these requirements.

8 However, some expert reports actually estimate an explicit discount rate and growth rate.

9 This model is well documented in the literature. See for example Francis (1991). More rigorously:

$$\pi_{i0} = \sum_{t=1}^{a} \frac{d_{i,t}}{(1 + r_i)^t}$$

Where \( d_{i,t} \) = dividend per share at time \( t \) for company \( i \)

\( r_i \) = required rate of return by equity holders for company \( i \)

\( \pi_{i0} \) = price of the share today

Assuming constant growth of dividends \((g_0)\), the model can be simplified as:

$$\pi_{i0} = \frac{d_{i,1}}{r_i - g_0}$$

Dividing both sides of equation (2) by today’s earnings per share \((e_{i0})\) the \( p/e \) ratio or the multiplier \((m_{i0})\) can be defined for company \( i \) as:

$$\pi_{i0} = \frac{d_{i,1}}{e_{i0}} \frac{e_{i0}}{r_i - g_0} = m_{i0}$$

10 This may not be obvious but to relate the current share price to last year’s earnings, rather than next year’s earnings, only makes sense if it is assumed that the best estimator of future earnings is last year’s earnings. The evidence by Finn and Whitried (1982) supports the credibility of this assumption. However, under this assumption the multiplier approach becomes a tautology as the earnings per share estimate in equation (3), footnote 9, would cancel out and would suggest that the best estimate of value is the current share price.

11 See for example, Copeland, Koller and Murrin (1990), James (1990) and Sykes (1992).

12 Already in the 1970s the accounting profession both overseas and in Australia suggested different specific and general price level adjustments for reporting purposes.

13 “Current market” price such as the three-month average of the pre-bid price, which is likely to exclude the expectations of a takeover announcement.

14 There could be some administrative and regulatory problems with such a scheme, such as: the ASX listing rules prevent target companies from issuing new equity securities during a takeover; accounting firms may not be able to hold the shares due to their audit responsibilities; and compulsory acquisition of these minority shares may have to take place at the final offer price or valuation price, whichever is lower. However, none of these difficulties is insurmountable.

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