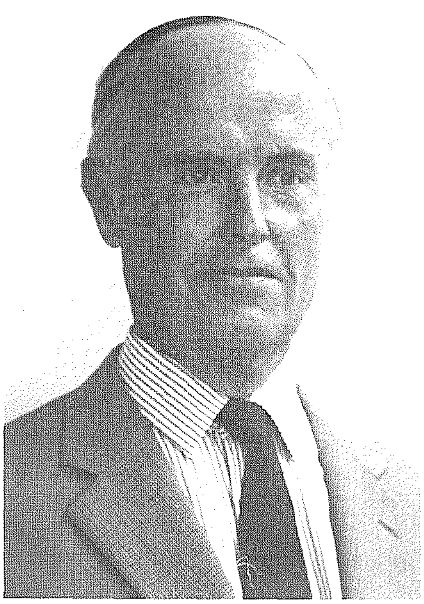
HOW TO BE FAIR AND REASONABLE

IS THE NCSC ASKING TOO MUCH?



by RON BUTLER

The consultant's dilemma when valuing unidentified resource reserves and exploration properties remains unresolved despite the NCSC'S new policy on technical reports. Some of the NCSC requirements are unrealistic.

On June 20, 1988, the National Companies and Securities Commission issued its policy statement on "Expert Technical Reports on Mining, Oil and Gas Properties". This document sets out what the NCSC sees as appropriate standards for reports prepared by independent experts for inclusion in prospectuses and takeover documents. The final version of the statement incorporated a number of changes made following the circulation of a discussion draft.

The commission's statement covers:

- experts' qualifications and experience;
- experts' independence;
- objectivity and completeness of reports;
- the need to address economic aspects;
- valuations and valuation methodology.

The standardisation and clarification of many aspects of reports by consultants is most welcome, although I have reservations about the commission's comments on valuations.

Five of the statement's fourteen pages are concerned with the "Valuation or Assessment of Vendor Consideration". In view of most consultants' concern with this aspect of reporting, it is disappointing to have to comment that the commission's requirements for valuations are onerous, and would appear to be unrealistic and unrealisable in many cases. Little consideration appears to have been given to how the consultant can achieve the NCSC objectives.

Clearly, the NCSC would prefer the reporting consultant to place a dollar value on each and every property. The consultant is asked to spell out the values of the individual tenements, or groups of tenements, as well as giving the overall value, of the portfolio. The latter "may be different from the total of the individual tenement values". It is not clear what this difference is. Is it a premium attributable to the strategic advantage, of holding the key properties in an area, or a portfolio of properties for a single commodity, or the expectation that the exploration team will continue to successfully acquire properties of great merit, or, perhaps, some other merit the properties as a group may have?

It is the NCSC opinion that the consultant "may be aware" that there is a range of possible valuations, and that he should, therefore, consider the possibility of setting out the worst and best valuations as well as the most likely value. Surely, the "worst value" must always be zero for a property without identified resources?

The NCSC also concedes that the expert may be "unable to arrive at a specific value for a tenement". In this instance, a statement as to the reasonableness or otherwise of the consideration being paid would be acceptable. The expert, however, would be required

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to state the full grounds and reasons for his inability to arrive at a specific value. Obviously, the NCSC would prefer us to provide a dollar-value, if at all possible.

How does the consultant arrive at his valuation, or range of valuations (with a most likely value)? The statement does not give us much guidance, although a section (7.3-7.8) entitled "Valuation Methodology" adjures us to make use of "normally accepted valuation methods". It goes on to require the expert to name his methodology, giving reasons for its selection, and to provide a sufficiently detailed account of the method adopted that an independent expert could arrive at a similar valuation.

There is also a recommendation that the expert should consider whether "the capitalised cost assigned the tenement is representative of the value and the commission's opinion is expressed that the carrying value will not reflect the fair market value in the majority of cases". Presumably the capitalised cost and carrying value are the same, namely acquisition costs and exploration expenditure incurred to date, less any expenditure written-off. These capitalised costs should normally consist of tenement acquisition costs and exploration costs, i.e., direct expenditure on the property. Only in the case of a company acquiring an interest by purchase (when there is a vendor's consideration involved) is there any possible element of premium in the capitalised book value.

The NCSC requires the consultant to provide in his report full justification for the premium involved when his valuation exceeds the carrying value. The statement goes on, however, to state: "Where the valuation of the tenements fall short of the carrying value, the premium element or goodwill must be justifiable given market forces. The amount of goodwill or premium shall be fully disclosed in the report for the benefit of prospective investors. Because the investors will have been fully informed of the extent of the premium or goodwill element involved, the Commission will not object to the inclusion of such a valuation."

I presume the premium element to be justified is a component of the capitalised value.

This would be a fairly rare occurrence in our experience. If the premium could not be justified, the company should be prepared to write off an additional capital amount, as it would otherwise tend to inflate the balance sheet.

It seems to me from the foregoing that consultants need to put their heads together in order to devise a standard procedure for handling this matter of valuations, if they are going to avoid the traps inherent in the NCSC policy document.

We need to set some procedure which is acceptable to the consultants and yet also meets the fundamental objectives of the NCSC policy. Perhaps we could begin with some basic points on which we can agree:

- All mineral properties are speculative, but some (grass-roots exploration tenements, for instance) are more speculative than others.
- Discounted cash flow techniques of valuation can only be applied to the valuation of properties with identified and quantified resources.
- There is no other scientifically-based valuation methodology applicable to mineral properties. Any other procedure for valuing must be subjective and dependent in large degree on an expert's opinion. There may be considerable variation of opinion between any two experts.
- The value of any exploration property could be defined as the total of the following components:
  - tenement acquisition costs (but excluding any premium element involved in a cash purchase);
  - exploration expenditure to date;
  - a technical premium which represents the enhanced prospectivity arising from the exploration activity (it should be noted that this component may well be negative where exploration results have been disappointing and the conceptual target has been discounted);
  - a market premium which is unrelated to the merits or attributes of the property, but reflects market forces at the time of valuation. Because this premium is independent of any technical assessment, the consultant may have difficulty in judging it to be reasonable, or otherwise.
- The value of a property with identified resources, either undeveloped or developed, could also be defined in the same way, with the technical premium element being replaced totally or in part by a DCF valuation of resources.

Let us look at the valuation of

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exploration tenements without defined resources. It is my belief that it is contrary to the interests of the consultant and the industry to publish a dollar-value for individual properties. In the first place, the value is highly speculative, and there will be a wide range of possible values, with considerable disagreement between equally qualified experts. Because of the laws of chance, in most cases the value will be shown to be excessive in the course of time. In rare cases, when the jackpot bonanza is struck, the value will have been low.

More important, as we have seen in the recent mining boom, the publication of property values tends to cause those values to escalate. Inevitably, the consultant is under pressure to align his values with those of other properties which are perceived to be comparable. Values tend to climb, because the promoters tend to choose flattering comparisons. If the expert sees two properties as similar, the value assigned will be either the same or higher, never lower!

I would suggest that for independent valuation reports on exploration properties, consultants should:

- Make a general statement that there is no objective method by which a value can be assigned to an exploration property. Its value is highly speculative.
- Provide information on the company's past expenditure on the property (capitalised value) and the future exploration budget commitment, to give a measure of the value placed on the property by the company. If the property has been purchased or joint ventured, full details should be given.
- The premium existing between the overall consideration and the capitalised value of the portfolio of exploration properties should be stated and the expert's opinion expressed as to whether it is reasonable. In order to do this, the consultant will need to formulate a private opinion on the value of each of the properties.
- If the expert is unable to support the premium as a reasonable one (and possibly even if he does), he should indicate for the benefit of prospective investors what expectations have to be realised to justify the premium. By doing so, he would provide the investor with a basis for drawing his own conclusions as to the merit or otherwise of what is offered. □

CREATIVE ACCOUNTING

This comment on the valuation of assets was published last December as an editorial in the weekly London-based magazine *The Mining Journal.*

A British food conglomerate, Ranks Hovis McDougall, decided recently that its "brand names" should be given a particular value and, further, that this value should be included in the company's balance sheet.

There can be no doubt that brand names like "Mr. Kipling" cakes (or "MG" in the car world) do have significant earning power and are therefore important assets. However, any attempt to include them in the balance sheet at a particular value completely misunderstands the point and purpose of a balance sheet. So much so that it seems important to call "foul" before a mining entrepreneur decides that mineral reserves, or even mineral resources, can be treated in the same way!

Bland generalisations are no basis for forming an opinion on a company's value.

The logic behind valuation of brand names is that it gives a better idea of a company's value. This could be equally valid with ore reserves in the mining industry. The reason for the parallel between such different assets and such different industries, however, is simply that the reporting standards of the major companies have been quite inadequate for years and almost any change might seem to be an improvement. Company directors/managers appear to believe that shareholders will not understand the sophisticated intricacies of their particular business and have therefore sought to present a list of bland generalities in their reports. Mining directors have been particularly guilty in this sense, with the justification that "mining is a highly specialised business".

Bland generalisations, however, are no basis for forming an opinion on a company's value and this fact has now come home to roost; in a series of takeover bids in a range of industries, the threatened groups are claiming that their assets are undervalued. This is probably true, but how can a satisfactory valuation be made on a typical annual report (the 10-K Report published in the US is a special case). The information simply isn't there, but "creative" balance sheets are not the answer.

The audited profit-and-loss account and the audited balance sheet are reports to the shareholders to demonstrate that the shareholders' agents — the managers and directors — have dealt with the assets honestly (or at least, within the law).

Their purpose is to demonstrate, in detail, where money has been spent and where money has been earned; the auditors, on behalf of the shareholders, have the opportunity of checking this to a very detailed point. The balance sheet is simply a statement, or a photograph at a point in time, of the profit-and-loss account process. It lists outstanding debts and credits, the cost of stock and the cost of capital assets. Depletion and depreciation policies and write-off programs for obsolete plant and stores are important management tools but they should not be used in the valuation process.

The "creative" valuation of assets in the balance sheet must be criticised for two reasons. First, it undermines the basic purpose of the profit-and-loss account and the balance sheet process. Second, it can provide an excuse to continue the inadequate reporting procedures. If company directors are anxious that shareholders recognise the full value of the business, and that in turn this is reflected in the market, then they must tell their shareholders about the business — in detail!

The place for this is in the directors' report and it may well be appropriate, in their report, for directors to give an indication of their idea of the value of different elements of the business. It is already absurd that major companies with interests worldwide and a turnover of over 5 billion pounds should seek to report to their shareholders (and the many other properly interested parties) in less than 50 pages. A few extra lines in the balance sheet are certainly not going to improve the situation and could make it very much worse. □