INTRODUCTION

1.1 In this paper I will use the term "the valuation profession" to mean that group of persons who conduct valuations of business interests (including shares and trust units) in Australia. As discussed below, there is no generally recognised Australian qualification or accreditation system for business valuers per se, although, it would appear that most valuers hold professional qualifications as accountants or financial analysts.

1.2 I am mindful that this is a conference for forensic accountants. Many of you will be concerned with issues arising in the context of litigation. A very significant part of forensic accounting work has to do with valuation issues. Much of the valuation work relates to closely-held companies and businesses. However, the scope of my remarks relates to business and share valuation generally. The issues I wish to canvass briefly are as follows:

(i) the absence of a formal Australian professional accreditation system for share / business valuers;

(ii) as a corollary to (i), the absence of professional standards relating to the conduct of valuations and the undertaking of valuation work;

(iii) difficulties with the meaning of the term "value";

(iv) what constitutes a "valuation"?

(v) the public and Court perception of valuers and of disputes between valuers;

(vi) transparency as regards the estimation of capitalisation and discount rates and minority and marketability discounts;

(vii) the significance of legislation and decided cases; and

(viii) the risks and rewards of valuation practice.

I will conclude with some brief remarks about the imminent formation of the “Business Valuation Special Interest Group”.

2 IS EVERY ACCOUNTANT AN EXPERT VALUER?

2.1 The Oxford Dictionary for the Business World defines “professional valuation” as:

“n. assessment of the value of an asset (share, property, stock, etc) in the balance sheet or prospectus of a company, by a person professionally qualified to give such a valuation. The professional qualification necessary will depend on the asset; for example, a qualified surveyor may be needed to value property, whereas unquoted shares might best be valued by an accountant.”

It is not obvious why a surveyor should be qualified to value real estate. Neither is it immediately apparent why an accountant should be qualified to value shares.

2.2 In a report entitled “Shareholder Remedies” published in October 1997, the UK Law Commission recommended law reform designed to make shareholder remedies more affordable and more appropriate to modern conditions. The report canvasses the question of who should value the shares of an outgoing shareholder:

“In the consultation paper we proposed that the valuation of the exiting member’s shares should be carried out by an independent accountant… In our revised draft we refer to an “independent person who appears to have the requisite knowledge and skill”. We accept the point made by several respondents that the auditor or even an accountant may not always be the best person to value the shares. The auditor may have a conflict of interest so far as his duties to the outgoing shareholder are concerned because of his ongoing relationship with the company. Moreover, share valuation requires particular skills which do not necessarily form part of an accountant’s training or practice; on the other hand, there may also be experienced valuers who are not accountants.” (emphasis added)

2.3 The perception that any accountant/auditor can competently undertake a valuation persists in some quarters. Section 139FB of the Income Tax Assessment Act provides, as regards the valuation of unlisted shares for the purposes of Division 13A of the Act (employee share schemes) that one way of establishing the “market value” of unquoted shares is by reference to “a written report given to the person from whom the taxpayer acquires the share by a person who is a ‘qualified person’: A person is a “qualified person” in relation to valuing a share if the person is (subject to qualifications relating to independence) “registered as a company auditor under the law in force in a State or Territory”.

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1 Oxford University Press, 1993
2 “Shareholder Remedies”, Report Law Com No 246, published 24 October 1997, at p66
3 Consultation Paper No 142, Part 19
4 Section 139FB(1)
5 Section 139FG
Constitutions requiring a “fair value” to be set by the auditor when a shareholder wishes to dispose of shares.

2.4 In *Kizquar*\(^6\) Young J reiterated the views he had expressed in *Sapir*\(^7\) about the standing of accountants as “expert valuers”:

“In *Sapir* I observed that I was not then convinced that merely because a person was a chartered accountant or had given evidence on share valuations in other cases before a court that that person was necessarily to be considered an expert in the valuation of shares. I said then and I still hold that the evidence of such a person is very useful to the Court in saving the Judge having to commence his calculations from raw data, but the conclusions reached by the person concerned are not to be considered in the same light as expert evidence.”

2.5 Although perhaps not everyone would agree, it is submitted that not every accountant/auditor has the requisite training and experience to be qualified to undertake business valuation work. Before considering the position of the “valuation profession” in Australia let us consider briefly the position in some other common law countries.

3 THE VALUATION “PROFESSION” OUTSIDE AUSTRALIA

In this section is reviewed briefly the identity and role of professional bodies in each of Canada, the United States, the United Kingdom, and New Zealand and two international bodies. The position in Australia is considered in the following section.

Canada

3.1 In Canada the body now known as the Canadian Institute of Chartered Business Valuators (“CICBV”) was formed in 1971 following the proposal in November 1969 to introduce capital gains tax. Under the new regime, which came into force on 1 January 1972, capital gains arising after “Valuation Day” (31 December 1971, known as “V-Day”) are assessable. The “adjusted cost base” of property owned on Valuation Day is “its fair market value”. That term is not defined. The legislation does not require a valuation to be undertaken until the disposition of the property and neither is there a requirement that the valuation be undertaken by a qualified valuer. However, it appears that many private company owners took the view that it would be prudent to obtain an independent valuation earlier rather than later. The requirement for business valuations was increased also by the introduction of minority shareholder dissent and oppression remedies, the issue of various valuation related policy

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\(^6\) *Kizquari Pty Ltd v Prestoo Pty Ltd* (1993)11 ACLC 568

\(^7\) *Sapir v Sapir (No 2)* (1989) FLC ¶92,047
statements by the Ontario Securities Commission, and changes to the Family Law Acts of certain of the Provinces and the Federal Divorce Act\(^8\).

3.2 These changes have led to the formation of specialised departments within the major accounting firms and a range of new small firms specialising in business valuation. Many of the members of these practices appear to be members of the CICBV, which offers extensive training, maintains rigorous accreditation standards and publishes regularly materials on valuation-related issues. On 3 December 2002 the CICBV entered into an accreditation agreement with The Canadian Institute of Chartered Accountants. The main objective of this agreement was to accredit the CICBV as the only body whose professional designation leads to recognition for a chartered accountant as a designated specialist in business valuation\(^9\).

**United States**

3.3 There are four\(^10\) major bodies involved in the education, accreditation and, to some extent, regulation of business valuers:

(i) the American Society of Appraisers ("ASA");

(ii) the National Association of Certified Valuation Analysts ("NACAV");

(iii) the Institute of Business Appraisers ("IBA"); and

(iv) the American Institute of Certified Practising Accountants ("AICPA").

3.4 These four US organisations have formed a Joint Business Valuation Task Force to make recommendations to the Appraisal Standards Board of the Appraisal Foundation in connection with USPAP\(^11\). The first three of these bodies themselves publish business valuation standards (much more detailed than USPAP). Those published by the ASA are the most comprehensive. The four organisations, together with the CICBV, have promulgated a "valuation glossary" and undertake other projects to attempt to make valuation practice

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9 *The Business Valuator*, CICBV, No 1, Vol 25, April 2001, at p1

10 Another significant body the present context is the Appraisal Foundation established in 1987. The focus of this body is largely on the setting of standards (known as the Uniform Standards of Professional Appraisal Practice, or USPAP) in connection with the appraisal of real estate and personal property. However it has promulgated two standards relating to business valuation. Compliance with USPAP is made mandatory for all federally related real estate transactions by the Financial Institutions Reform, Recovery and Enforcement Act and compliance has become widely accepted.

11 See Footnote 10
more consistent. A comprehensive overview of these organisations is given in Chapter 1 of Pratt\textsuperscript{12}.

**United Kingdom**

3.5 In the 1997 paper described at paragraph 2.2 above it was observed\textsuperscript{13}: “There is not yet a recognised professional qualification in the United Kingdom for share valuers. The Society of Share and Business Valuers\textsuperscript{14} in the United Kingdom is only in its second year of existence.” The Society is in its early days and does not at this stage appear to have any significant public profile\textsuperscript{15}, although some UK valuers include membership as part of their qualifications.

**New Zealand**

3.6 There is no professional body concerned only with business valuation in New Zealand. The Institute of Chartered Accountants of New Zealand has promulgated Advisory Engagement Standard No.2 2001 (effective from 1 April 2003) entitled “Independent Business Valuation Engagements”, which applies when a member is providing a business valuation report in the role of an independent business valuer. The standard lays down certain standards to be adhered to in relation to planning, documentation and reporting performance of the assignment: see paragraph 6.3 below.

**International Bodies**

3.7 The European Group of Valuers (“TEGoVA”) was established on 4 May 1977 in response to the increasing integration of Europe. Its members include professional bodies representing valuers from countries including Belgium, France, Germany, Ireland and the United Kingdom. The objectives of the body include the writing and promoting of valuation standards for Europe, the management of a system of certification, to promote the minimum educational requirements with which European professional bodies must comply, and to participate in the work of the International Valuation Standards Committee\textsuperscript{16}. TEGoVA has promulgated various standards (including Standard 4: “Valuation Bases”) and Guidance Notes (including Guidance Note 5 “Valuations for the Purpose of Financial Reporting”) and Guidance Note 7 dealing with business valuations.

3.8 The International Valuation Standards Committee (“IVSC”) was established in 1981. It’s principal objective is “to formulate and publish, in the public interest,
valuation Standards and procedural guidance for the valuation of assets for use in financial statements, and to promote their worldwide acceptance and observance”. The second objective involves standardisation of standards among the world’s states. Membership of the IVSC is through national valuation societies and institutions. The members (representing 39 countries) include the Australian Institute of Valuers (see paragraph 4.3 below), the New Zealand Property Institute, the Royal Institution of Chartered Surveyors, the Appraisal Institute of Canada and the American Society of Appraisers. Although, as the membership suggests, the primary focus is real estate, the IVSC clearly intends that business valuation be within its scope. As at February 2005 the IVSC has issued three international valuation standards, two “Applications” and eleven guidance notes including Guidance Note 6 dealing with business valuations.

4 THE VALUATION PROFESSION IN AUSTRALIA

4.1 In Australia, there are a wide range of circumstances which call for, or have in the past called for, valuations:

(i) prior to 1972 death duty and gift duty were imposed by the State and Federal governments on the value of assets at the date of death;

(ii) valuations are required for several important areas in relation to the establishment of income tax liabilities, including those dealing with capital gains tax, employee share acquisition and tax consolidation;

(iii) Stamp Duties have applied for many years in relation to documents (and later, transactions) involving sales of shares and businesses;

(iv) valuations of the assets of the parties, including shares and business are routinely required in the context of division of property pursuant to the Family Law Act and, to a lesser extent, the various State legislation relating to de facto relationships;

(v) valuations are often required pursuant to private company constitutions when shareholders wish to transfer their shares;

(vi) valuations of shares and businesses are routinely called for in relation to business purchases and mergers; and

(vii) valuations are needed in a wide range of commercial litigation, including shareholder and partner disputes.

4.2 Despite the significant and growing need for high quality valuation opinions, there has not been formed any specialised valuation body in Australia and neither is there a significant number of firms undertaking only or mainly valuation work. Valuations for the purposes of mergers and acquisitions of
public entities and larger private entities are commonly undertaken by a relatively small number of merchant banks, the “corporate services” groups within the “Big 4” accounting firms and a small number of “mid-tier” accounting firms. The last two of these also undertake much of the valuation work required for the purpose of litigation of various kinds, although the interest in forensic work among smaller accounting practitioners appears to have blossomed. Valuations for small acquisitions and tax purposes appear to be most commonly undertaken by the accounting advisers to the vendor and purchaser clients.

4.3 There is no recognised valuation qualification in Australia and no bodies the equivalent of those in Canada, the United Kingdom or the United States described above. There exists a body known as the Australian Institute of Valuers ("AIV") whose focus is on the valuation of real estate, plant and equipment, and jewellery. The AIV is a member of the International Valuation Standards Committee described at paragraph 3.8 above, which body clearly sees business valuation as within its purview. It may be that the AIV will seek to extend its influence in this area.

4.4 The Institute of Chartered Accountants in Australia ("ICAA") and CPA Australia organise the delivery of ad hoc courses of up to one full day on valuation principles but have promulgated no technical standards in the area. While some Accounting Standards touch upon valuation issues, none deal in any detail with methodology or valuation practice. The ICAA has promulgated a standard dealing with forensic accounting practice, but there is no specific reference therein to valuation assignments. It might be expected that either the ICAA or the CPA Australia might have before now taken the lead in developing standards and accreditation in the valuation area. However, it appears that the limited resources of these bodies (exacerbated by the failure of several attempts to merge them), has hindered that development. Further, these bodies do not have “authority” over all valuers.

4.5 The Securities Institute of Australia ("SIA"), established in 1966, is a professional body representing the securities and financial services industry. Its 2003 Annual Report indicates that it has more than 10,000 members and 25,000 students. Its mission is to provide practical education, foster ethical and effective markets and advocate high levels of professional conduct. The SIA offers education in a wide range of areas relating to applied finance and investment, financial planning and advising, mortgage lending and financial services. The SIA offers two courses dealing with valuation entitled “Applied Valuation” and “Industrial Equity Analysis”. It appears the SIA does not see

17 Although there appears to be a (very small) sub-group of members of this body who are involved in business valuation the Institute does not have any role in accreditation, or training or standard setting specific to that area.

18 AASB 1046, issued in January 2004, and AASB 2 which applies to financial year ends beginning on or after 1 January 2005, deal in some detail with methodology in connection with the valuation of options. Certain mandated requirements mean that valuations in accordance with this standard will not always conform to a “willing buyer, willing seller” – type valuation.
itself as training share valuers per se and that body does not exercise any supervisory function.

4.6 The Australian Securities and Investments Commission ("ASIC") "enforces and regulates company and financial services law to protect consumers, investors and creditors". In the course of its activities ASIC periodically issues Policy Statements as formal declarations of its policies, and Practice Notes, for the guidance of practitioners on reporting and compliance matters. Certain of these documents are relevant to valuation practitioners providing independent expert's reports in the context of, in particular, takeovers, the compulsory acquisition of minority interests and schemes of arrangement. They generally do not apply in the context of the day-to-day valuation of closely held companies. The Statements / Notes contain some broad description of the attributes of an "expert". For example:

"An expert, in relation to a particular matter, is a person whose profession or reputation gives authority to his or her statements in relation to that matter...Whether a person's profession or reputation gives such authority to his or her statements is a question of fact."

4.7 The requirements in paragraph 43.18(c) that the expert sets out in the report "his or her qualifications and experience" suggest that these are relevant but there are no specific requirements other than that "the expert holds the licenses or authorities necessary for providing the type of advice sought". These ASIC pronouncements do not contain any definition of "value". Practice Notes 43 ["Valuation Reports and Profit Forecasts"] does however suggest that the expert should define what he or she means by that term:

"....Where appropriate, the expert should provide a glossary, especially where the definition or interpretation of specific terms is central to the report (such as "market value" or "investment value")."

4.8 The Financial Services Reform Act 2001 extensively amended Parts 7.6 to 7.8 of the Corporations Act, which constitutes a licensing regime in connection with financial product advice and dealing. After some considerable lobbying by the accounting/tax bodies, regulations were introduced to avoid the need for "persons" (not just accountants) to be licensed to perform certain valuation and other services. Although the educational and competence requirements for licensing are not overly prescriptive as regards valuation qualifications there are nonetheless requirements to "maintain competence", train

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19 See “About ASIC” at www.asic.gov.au
20 Practice Note 43 “Valuation Reports and Profit Forecasts”. para 43.18
21 Paragraph PN43.18(b)
22 PN43.37. It seems clear that ASIC sees a clear distinction between the meaning of value, on the one hand, and valuation methodology, on the other. The Practice Note outlines certain methods which ASIC suggest the expert should “consider” but, quite properly, does not prescribe which method(s) the expert should apply.
23 See particularly Regulation 7.1.29(3)(c)
representatives and ensure their competence which do not apply to persons providing services which do not require licensing.

4.9 The Rules of the Australian Stock Exchange require the preparation of an independent expert’s report in connection with certain transactions between a listed entity and “persons in a position of influence”. The ASX rules will not generally concern a valuer of closely held businesses or shares. They do not set out what qualifications an expert is expected to have and they do not define “value”, nor do they prescribe valuation standards.

Education

4.10 The larger training organisations occasionally conduct seminars of up to two days focussing on, or including coverage of, valuation topics. However, again, these courses do not purport to deliver, and cannot deliver, rigorous formal education in the area. Various university programmes include components relating to valuation but no university or other body offers a formal course dealing with valuation in a comprehensive manner akin to the approach taken by, for example, the CICBV in Canada. As indicated above the SIA offers the most extensive education on valuation but it is nonetheless much less extensive than that offered by the CICBV.

4.11 Overall then, Australia has some way to go to build a formal “valuation profession”. This is not to say that there does not exist a body (but not a formal body) of highly trained and experienced business valuers. There is no system of accreditation in Australia and, at least in the context of advising on sales and purchases of unlisted companies or interests therein, anyone can describe himself or herself as a “business valuer”. In general, there are no minimum education or experience qualifications required. Of course a person obtaining valuation work on the strength of misrepresentation as to the ability to carry it out, or simply failing to deliver a report of sufficient quality (in accordance with generally accepted “standards”, established by reference to practice rather than a body of “rules” promulgated by an authoritative body) risks legal action from an aggrieved client and possibly third parties, and possible disciplinary proceedings from the professional body (if any) to which he or she belongs. However, the incentive for quality provided by the availability of such avenues for redress is a poor substitute for the raising of standards by organisation, accreditation, research and education.

24 See generally Corporations Act sec 912A
25 See Rule 10.10.2
26 There are exceptions. For example, as noted above, the Income Tax Assessment Act requires that only a qualified auditor can undertake a valuation for the purposes of sec 159FB dealing with the valuation of shares for the purposes of employee share schemes.
5 WHAT DOES “VALUE” MEAN?

5.1 The first step in seeking to establish the “value” of an asset is to determine what “standard of value” is to apply. That is “what do we mean by “value”? The answer to that question may generally be determined based on the purpose of the valuation. The concept of “standard of value” must be distinguished from that of “valuation methodology” which is not what value means but how, once defined, value is determined. An issue of enormous significance to valuers is the problem of defining what the valuer is supposed to be doing – if I am forming an opinion on value, what does “value” mean? Although it is gradually becoming less common, many valuation reports do not set out any definition but proceed immediately to discuss methodology. Even where the valuation standard is stated (eg “fair market value”), care must be taken to define what is meant, because of the absence of generally agreed definitions of commonly used terms. Just as importantly, the valuer must make sure that he or she is applying the correct standard. Many disputes between valuers arise because they are simply not performing the same exercise. This is particularly important in the context of litigation, where valuers will often be acting on instructions.

Market value, fair market value and fair value

5.2 The most commonly accepted standard applied virtually world-wide in the valuation of real estate is “market value”. The International Valuation Standards Committee defines “market value” as follows:

“market value: the estimated amount for which an asset should exchange on the date of valuation between a willing buyer and a willing seller in an arm’s length transaction after proper marketing wherein the parties had each acted knowledgeably, prudently and without compulsion.”

The IVSC suggests that “Business valuations are commonly sought and performed on the Market Value applying the provisions of [IVS 1]. Where other bases of valuation are used, with proper explanation and disclosure, the provisions of IVS 2 are applied.”

5.3 The term “market value” is that used in the context of income tax to denote this “willing buyer willing seller” construct. However, there is no definition of “market value” in he Income Tax Assessment Act. For example, a paper entitled “Market Valuation Guidelines” provides broad guidance as to how the Australian taxation Office will administer the market valuation provisions of the consolidation regime. The term “market value” is not defined. The Guidelines comment:

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27 IVS 1, para 3.1
28 International Business Guidance Note No.6 para 1.2
29 Being Section C2 of a document entitled “Consolidation Reference Manual”.
30 At p15
“The term ‘market value’ has not been defined for the purposes of consolidation. The definition in current tax law does not specifically define market value. As a result, for the purposes of consolidation, the term takes on the meaning ordinarily applied to it when used on its own without any qualifications.”

It is not clear what the second sentence means. In any event, there is no “definition” of “market value” in the current tax law. The Guidelines go on:

“Business valuers in Australia typically define market value as:

The price that would be negotiated in an open and unrestricted market between a knowledgeable, willing but not anxious buyer and a knowledgeable, willing but not anxious seller acting at arm’s length.”

5.4 In the public context, Australian share and business valuers generally use as a standard **fair market value**. It appears that that term derives from United States usage - “fair market value” is “the most widely recognised and accepted standard of value related to business valuations in the United States”\(^{31}\). The American Society of Appraisers defines “fair market value” as:

“the amount for which property would change hands between a willing seller and a willing buyer where neither is acting under compulsion and where both have reasonable knowledge of the relevant facts”.

Because firms with strong US connections undertake many Australian listed public company valuations, it is not surprising that US practice has had a significant influence in Australia (and that influence continues). The definitions of “fair market value” used in public reports, and often in substantial unlisted company valuations, are generally in line with that set out above, with some variations discussed at paragraph 5.7 below. Perhaps remarkably, in the light of common practice, the Securities Institute of Australia promotes the use of the term, “market value” rather than fair market value, although it says that the two “effectively mean the same thing”\(^{32}\). Here\(^{33}\) is the SIA’s “conventional definition” of “market value”:

“the price that would be negotiated between a knowledgeable and willing but not anxious buyer and a knowledgeable and willing but not anxious seller acting at arm’s length within a reasonable time frame.”

5.5 The man in the street would be bemused to learn that Australian accounting standards\(^{34}\) do not use either of the terms “market value” or “fair market value”

\(^{31}\) Pratt et al op cit p 28
\(^{32}\) Securities Institute of Australia, E102 *Applied Valuation*, page 1-6, 1-7: “market value” is the most commonly applied standard in real estate appraisals - the concepts are essentially the same.
\(^{33}\) Just prior to stating this definition the SIA describes market value as: “an estimate of the price that can realistically be expected to be realised for an asset ...if it was to be sold in current market circumstances.”
\(^{34}\) See, for example, Australian Accounting Standards AASB 119 *Employee Benefits*, (July 2004) para 7; AASB 132 *Financial Instruments: Disclosure and Presentation* (July 2004), para 11
to denote this “willing buyer willing seller” concept; rather, the term used is “fair value” defined to mean:

“...the amount for which an asset could be exchanged between knowledgeable willing parties in an arm's length transaction”.

Certain of the standards extend the definition to the valuation of liabilities by the addition of the words “or liability settled,” after the word “exchanged” in the above definition.

5.6 Although the wording of the various definitions is slightly different it is suggested that the essential features of the definitions of “market value”, “fair market value” and “fair value” given above are the same. The failure to adopt uniform terminology in the vitally important and obviously related fields of accounting, tax and finance is unfortunate. It is little wonder that there are often failures to properly come to grips with what is meant by “value” in valuation practice and litigation involving valuation issues.

5.7 The problem does not stop there. Even where two valuers adopt the same standard of value there can be nuances in their definitions which mean that they may not be undertaking exactly the same exercise. Consider:

Example: In their expert’s report in relation to the 2000 offer by Shell for Woodside, Grant Samuel say [at page 49]:

“The value of each asset has been estimated on the basis of fair market value, defined as the maximum price that could be realised in an open market over a reasonable period of time assuming potential buyers have full information.” [Italics added] [Definition 1]

In their report on the same takeover offer Deloitte Corporate Finance Pty Limited say [at page 4]:

“Woodside has been valued at fair market value which we have defined as the value at which it would be expected to change hands between a knowledgeable willing buyer and a knowledgeable willing seller, neither of whom is under any compulsion to buy or sell.” [Italics added] [Definition 2]

Do these definitions of “fair market value” mean the same thing? Grant Samuel are concerned with the “maximum” price while Deloitte look at the “expected” price. Grant Samuel do refer to the seller but simply to what might be obtained for the asset from one of the potential buyers. Deloitte posit that the seller is knowledgeable and willing. Grant Samuel have used the qualifying phrase “over a reasonable period of time” which does not appear in the Deloitte definition. The Grant Samuel definition impliedly relates to the actual seller; the Deloitte definition refers to “a knowledgeable willing seller”. The Grant Samuel definition appears to be concerned with all actual prospective buyers; the Deloitte definition talks of “a knowledgeable willing buyer” which appears to suggest a hypothetical person. The Grant Samuel definition

35 See, for example, Australian Accounting Standard AASB 139 Financial Instruments: Recognition and Measurement (July 2004), para 9

36 This distinction follows that made between the US and Canadian definitions of “fair market value” in the glossary described at paragraph 3.4 above)
assumes that the buyer has “full information” but the Deloitte definition merely requires the buyer to be “knowledgeable”.

5.8 Difficulty arises where there is no market or only a very limited market for the shares being valued. One approach might be to simply conclude that the shares then have no “value” – that view sits uncomfortably with many. An alternative approach is to assume the existence of a “notional” or “hypothetical” buyer. One then must ask what price that person will pay for the shares – but if one decides he or she will pay the “fair market value” there arises a difficulty with circularity of reasoning which has bedevilled many of the decided cases since Spencer, probably the case most often referred to in Australian valuation literature.

Value to the owner

5.9 On one view the owner value is the fundamental standard of value – an asset can only have value to someone. Where an active market exists the “market value” represents a price at which some or many persons have determined to exchange the asset for cash. The vendors presumably believe the asset is worth (to them) less than the cash price they receive; the buyers believe the worth (to them) is more. There are, or may be, many holders and prospective holders of the shares. Holders who do not sell believe the shares are worth at least as much as (ie not necessarily the same as) the current “market price”. Prospective buyers who do not buy believe the shares are worth no more than the market price (and possibly a lot less).

5.10 The “value to the owner” standard is often referred to in Family Law proceedings relation to the valuation of non-controlling parcels of shares in family companies. While there has been considerable discussion of the term, valuers sometimes use it without defining it, and there is often confusion surrounding whether or not it is a standard of value or a valuation methodology. Let us suppose we can define it thus: “the minimum amount of cash which the holder of an asset would accept in exchange for the asset (or the amount which the owner or a prospective owner would pay rather than be deprived of the asset)”, or, as regards any particularly identified prospective holder, “the amount that that person would give rather than fail to acquire the property”. The critical issue is: once this standard, having been defined, is adopted, what methodology should be applied to determine value? If the methodologies are those used for determining market value then how should

37 Consider, for example, the following extract from the judgment in Spencer v. The Commonwealth (1907) 5 CLR 418 (at page 432):

“In my judgement the test of value of land is to be determined, not by enquiring what price a man desiring to sell could actually have obtained for it on a given day, i.e., whether there was in fact on that day a willing buyer, but by enquiring “What would a man desiring to buy the land have had to pay for it on that day to a vendor willing to sell it for a fair price but not desirous to sell?” [Italics added] What is a “fair price”?

38 Spencer v. The Commonwealth (1907) 5 CLR 418

39 See, for example, In the Marriage of Harrison (1995) FLC ¶92-618
their application be varied? If there is no variation in application, in what way is the standard different from market value?

Cyril: Marmaduke, you’re a reputable car valuer; what do you think is the value of my car?
Marmaduke: What do you think it’s worth?
Cyril: I wouldn’t part with it for a cent less than $20,000.
Marmaduke: Well, there’s you’re answer - the value is $20,000
Cyril: Do you mean I could get $20,000 for it?
Marmaduke: Oh no! You’d never get more than $15,000.
Cyril: I’m a little confused.

Other meanings of the term “fair value”

5.11 The use of the term “a fair value” (or “the fair value”, or perhaps just “fair value”) is sometimes seen in provisions of company constitutions dealing with transfers of shares between shareholders. There is generally no definition of the term in such provisions. There appears to be no generally agreed meaning of the term in that context. It would seem that it is generally appropriate in determining “fair value” in this context to have regard, inter alia, to the following matters:\footnote{See, for example, the decision in }\textit{Holt v Cox} 15 ACSR 313\footnote{See particularly sec 663B, 664C, 665B.}

\begin{itemize}
\item[(a)] the circumstances of the share acquisition;
\item[(b)] the expectations of an employee holding shares as to the likely future benefits to be generated from the holding, provided those expectations were reasonably held; and
\item[(c)] any expropriatory or forced element in the sale should not depress the price.
\end{itemize}

5.12 The term “fair value” is used in the Corporations Act in those provisions\footnote{In essence the valuer must calculate the value of the company, allocate that value between share classes and then allocate the value of each class pro rata among the securities in that class (without allowing a premium or applying a discount for particular securities in that class). The valuer is also required to take account of the consideration (if any) paid for securities in that class within the previous 6 months.} allowing for the compulsory acquisition of minority interests in a company, usually where the prospective buyer holds 90% or more of the issued shares. The purchase is to be effected at a “fair value” to be determined by an independent expert. The basis of fixing the “fair value” is prescribed by sec 667C\footnote{\textit{See particularly sec 663B, 664C, 665B.}}. “Fair value” so defined is not what many valuers would ordinarily consider to be “fair value”.

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\footnote{See, for example, the decision in }\textit{Holt v Cox} 15 ACSR 313\footnote{See particularly sec 663B, 664C, 665B.}\footnote{In essence the valuer must calculate the value of the company, allocate that value between share classes and then allocate the value of each class pro rata among the securities in that class (without allowing a premium or applying a discount for particular securities in that class). The valuer is also required to take account of the consideration (if any) paid for securities in that class within the previous 6 months.}
“Value” in the context of other areas of litigation

5.13 Where it is established that the conduct of those in control of a private company has been oppressive to the minority shareholders the court may order that the controlling shareholder buy the minority shares. In such cases the price may be fixed as a pro-rata value of the net worth of the whole company. That approach is not invariable. Further, the Court may have regard to the value of the shares disregarding the effect of the oppressive conduct. It should be carefully borne in mind that the Court has a wide discretion in these kinds of cases and it is not necessarily the case that an order will be made for compulsory purchase at pro rata value, or, indeed, for compulsory purchase at all. Further, it would be inappropriate to rely on the approach taken in one or more oppression cases in the circumstance where no oppression is alleged (or, indeed, where it is alleged but not proved, unless on instruction).

“Actual” / “real” / “true” / “intrinsic” value

5.14 Forensic accountants are sometimes called upon to opine as to the value of a business in circumstances where the buyer takes legal action after finding the business was not what he was led to believe. The valuer must understand what he is being asked to do and have some understanding of the difference in the formulation of damages claims under sec 82 of the Trade Practices Act, for breach of contract, and in tort. An issue which arises in these sorts of cases is the relaxation of the “rule” against use of hindsight in the valuation exercise. However, it is not an absolute abandonment of that rule, but only to the extent of imputing at the valuation date, full knowledge about circumstances existing at that time which may be drawn from subsequent events, not being “independent, extrinsic, supervening or accidental” events.

The resulting value is what the High Court has called the “actual”, “real”, “true” or “intrinsic” value.

5.15 In the HTW case it was found that the plaintiff would not have purchased a shopping arcade without written advice from the defendant as to rental income. It was found that the defendant was in breach of a duty to warn the plaintiff of the effect of the imminent construction of a nearby shopping centre. The High Court found that the measure of damages was (with some adjustments) the difference between the price paid by the plaintiff ($485,000) and (not the “fair market value”, or “market value”, but) the “true value” of the property at the date of purchase. The Court described the basis of measurement of damages thus:

43 See, for example: Dynasty Pty Limited & Ors v Coombs (1995) 13 ACLC, 1,290
44 See, for example, Re Bagot Well Pastoral Company Pty Ltd; Shannon v Reid (1993) 11 ACLC1
45 See HTW Valuers (Central Qld) Pty Limited v Aston Land Pty Limited [2004] HCA 54 [12 November 2004]
46 See previous footnote
“….the primary argument put by the plaintiff to the trial judge… was that the correct measure of damages, apart from consequential losses, was to deduct the value of the Plaza at the date of acquisition from the purchase price, and in assessing that value to bear in mind post-acquisition events. The approach of subtracting value from price is commonly employed where the acquisition of land, chattels, businesses or shares is induced by deceit……the test depends not on the difference between price and “market value”, but price and “real value” or “fair value” or “fair or real value” or “intrinsic” value or “true value” or "actual value" or what the asset was “truly worth” or "really worth" or "what would have been a fair price to be paid ... in the circumstances ... at the time of the purchase". This distinction is sometimes difficult to draw, but it is old and fundamental.”

6 WHAT IS A VALUATION?

6.1 How many times have you been asked for a “quick opinion”, “a preliminary view”, “an indicative valuation”, a valuation “just for stamp duty”? Some lawyers ask for an “appraisal” which they seem to believe is some sort of abbreviated or indicative opinion on value. Are there “valuations” and “valuations”?

6.2 The American Society of Appraisers has released various pronouncements styled “Business Valuation Standards”. Standard BVS-III, entitled “General Performance Requirements for Business Valuations”\(^47\), sets out three categories of what are described as “acceptable scopes of work”:

(i) “appraisal” - a procedure undertaken with the objective of expressing “an unambiguous opinion as to the value of a business, business ownership interest, or security ... supported by all procedures that the appraiser deems to be relevant to the valuation”;

(ii) “limited appraisal” - a procedure undertaken with a view to expressing “an estimate as to the value of the business ..... based upon consideration of limited relevant information [and] ... the conduct [of] only limited procedures”; and

(iii) “calculations” - a procedure undertaken to provide “an approximate indication of the value based upon the performance of limited procedures agreed upon by the appraiser and the client.”

6.3 No similar standards exist in Australia. New Zealand’s AES 2 (see paragraph 3.6 above – recall it applies “when a member is providing a business valuation report in the role of an independent business valuer” - appears to envisage that the valuer would ordinarily conduct what amounts to an “appraisal” in the ASA terminology. Paragraph 59 of that standard provides that:

\(^{47}\) Released January 1992
“Where the member has been limited in scope of review or where information provided to a member was incomplete, disclosure must be made of the limitation, the reasons given and, where possible, the potential impact on the business valuation conclusion.”

6.4 However, perhaps curiously (because there are then no standards or guidelines applying), the standard does not apply where independence is not asserted or reasonably assumed by the report user, or in relation to:48

“indicative valuation engagements, where the valuation conclusion is based upon the consideration of limited information provided to the business valuer, with no requirement to assess the reasonableness of the information or to gather further information, provided that the basis on which the valuation conclusion is to be formed is clearly set out in the terms of the engagement and any report produced by the business valuer as a result of the engagement;”

In any event, the New Zealand standard clearly envisages that the term “valuation” can have different meanings. Further it places an onus on the valuer (in the circumstances where the standard applies) to comply with the requirements of the standard as to performance, selection of the appropriate “approach” (or standard of value), the appropriate valuation “technique” (“methodology”), consideration of valuation parameters, gathering of evidence (and documentation of the evidence) and so forth. If these things are not done the valuer must say so in the report.

6.5 In the absence of any formal business valuation standard in Australia an opinion on a private company valuation may be based on an exhaustive analysis or a few quick calculations based on a whole range of assumptions, or even without consideration of what assumptions are being made. This is (or should be) an obvious issue for valuers generally, exacerbated by pressure from clients to minimise fees. The client should not assume that one valuation is as thoroughly performed as the next but clients are often unable to assess the quality of performance of a valuation assignment. In all courts there is a growing concern with the cost of obtaining expert evidence. Assuming valuers do not wish to, or are unable to, reduce their time charges, the only practical solution is to spend less time on the valuation. Unless time can be saved by efficiency the inevitable result is that the valuation is less thorough. In some cases that may be appropriate. However, if a matter comes to trial, cross-examining counsel will rarely hesitate to point out any areas where (he or she believes) the valuer should have done more work. Of course, some Court Rules provide that an expert must say that he or she “has made all reasonable enquiries”.

6.6 In a Media Release issued on 26 November 2004 the National Council of the Australian Property Institute announced that a “desktop valuation” does not meet the API’s professional practice standards and is not “a proper valuation”.  

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48 AES-2, para 3
The API warned, “Members should be aware that contravening the standards may jeopardise their membership to API, PI insurance criteria and professional standing.” Query whether, if a business valuation body is ever constituted, we shall see it take such a stance.

6.7 The purpose of the valuation will obviously bear directly on the scope of work. For example, a “calculation” (see paragraph 6.2(iii) above) would normally be of little use as expert evidence in any sort of litigation but it might be extremely useful in assisting a party to decide whether or not litigation may be worthwhile.

7 Public Perception of Valuers and Disputes Between Them

7.1 The Institute Members handbook includes the following passage:

“A distinguishing mark of a profession is its acceptance of its responsibility to the public. The accountancy profession’s public consists of clients, credit grantors, governments, employers, employees, investors, the business and financial community, and others who rely on the objectivity and integrity of members to maintain the orderly functioning of commerce. This reliance imposes a public interest responsibility on members. The public interest is defined as the collective well-being of the community of people and institutions that the members serve.”

7.2 Consider the following issues:

(i) do readers of our reports understand what we do?

(ii) are we adequately rewarded for skill and risk? – while it did not relate to business valuation per se, in the HTW Valuers Case (see paragraph 5.15 above) the defendant received $250 for an opinion on market rentals – the damages awarded exceeded $400,000. Some would say rewards are inadequate and constrained by competition in an environment where consumers cannot evaluate or compare quality. Others might say at least some valuation reports are a waste of money (see paragraph 7.5 below);

(iii) are some clients really only concerned about the “bottom line” and the cost of getting it – many clients assess the value of an opinion in terms

49 ICAA Member’s Handbook CPC paragraph B1. Dr Simon Longstaff [Response to address by the Hon. Justice Michael Kirby “Legal Professional Ethics in Times of Change”, St James Ethics Centre, 1996] put it this way:
“Where everyone else is encouraged to pursue self-interest in the belief that the ‘invisible hand’ will somehow ensure an increase in the stock of common good, professionals are required to act in a spirit of public service. In short, members of the professions must place the interests of others before their own.”
of the benefit to them of the valuation figure itself. So, for example, if the client is buying a business offered for sale at $500,000 and we value it at $250,000 the client might see more value than if we valued it at $400,000, depending, of course on how the client can use our valuation to persuade the vendor to lower its price. In the example at paragraph 8.3 below, Emily may be very pleased if Valuer B can convince the Family Court that the value of her shares is $64,000. She may be more pleased with the $180,000 value if she is trying to borrow money on the security of her shares. She may not understand or agree with either valuation. Of course the intrinsic worth of what the valuer does is quite independent of the answer produced;

(iv) is competition forcing efficiency, or does it lead to “corner cutting”? – see paragraph 6.6 above;

(v) are valuations generally “well regarded”? – see the following discussion;

(vi) is a valuation, or should it be, an attempt to replicate what a prospective buyer and seller would actually do in the “real world”? - see paragraph 8.2(i) below.

7.3 Ever since Adam and Eve retained Satan as a consultant the press given to those providing any sort of advice involving predictions of uncertain outcomes has not been universally good. Although he wasn’t speaking about valuers, St Augustine may have used similar words to these to describe them:

"The good Christian should beware of mathematicians and all those who make empty prophecies. The danger already exists that mathematicians have made a covenant with the devil to darken the spirit and confine man in the bonds of Hell."

7.4 The comments of Lord Justice Harman are well known:

"Accountants are the witch-doctors of the modern world and willing to turn their hands to any kind of magic."

Indeed, many “persons in the street” would have little hesitation in describing some of our valuation reports as the “magic” transformation of a sow’s ear into a silk purse or vice versa. Consider the dissenting views of Mr Justice Murphy in St Helen’s Farm expressing the disbelief many (at least non-valuers) feel
when presented with valuation reports opining that minority shares carry very much less than pro rata value:

“Once, it was almost an axiom that the whole was equal to the sum of its parts. In valuing company shares, it is evident that the whole of the shares may be worth more than the sum of the value of the individual shares. Some disparity is normal, but here the disparity between the value of the whole and the value of the sum of the individual shares as valued by the Court is extraordinary. The respondents claim that the assets basis in inappropriate. Valuation on an earnings basis is so low that it is illusory. The companies as receptacles for the gifts resemble magicians’ jugs into which great amounts of water can be poured without overflowing. The result is so bizarre that it warrants a departure from the approach of the trial judge.”

7.5 In a 1995 article in JASSA52, Professor Z P Matolcsy, Professor of Accounting at the University of Technology, Sydney, questioned whether independent expert’s reports were worth the cost:

“The ASC [predecessor to ASIC] persists with its requirement for independent experts reports in some takeover situations, despite the fact that most IERs rely on valuation techniques known to be inadequate….

…..there is no empirical evidence which would demonstrate the benefit of such reports. In fact, a number of legal cases and considerations raise serious doubts about the usefulness of IER’s”

Disagreements between valuers

7.6 The ability of the witch-doctor to maintain respect depended in large part on the absence of rival witch-doctors making inconsistent (with his or her) predictions. One important aspect going to the public’s perception of the credibility of business valuers is the (at least perceived) frequency with which they publicly disagree, typically in the context of a disputed takeover or in the context of litigation. Although it is not unheard of, it more likely than not that two share/business valuers called upon to value the same shares/ business will come to a different conclusion. Sometimes, both the relative and absolute amounts of the differences may be very significant. There are several possible reasons why valuers’ opinions may differ:

(i) one or both experts may be “wrong” in the sense that there is, for example, a mathematical error, or a technical error (eg a failure to deduct debt in valuing equity when using an EBIT multiple);

(ii) the experts may have proceeded on the basis of different sets of facts or assumptions used as part of the information base. For example, one valuer is aware of a particular fact (or is led to believe it is a fact) that is important [eg the loss of the major client or customer or the need to completely rebuild the main plant] and one is not;

(iii) the experts may be applying different standards of value, eg one valuer may be opining on “fair market value” and the other on “value to the owner”;

(iv) the valuers may be valuing different things – for example one valuer may include “special benefits” in the value of shares for the purposes of sec 667 and one may not;  

(v) one or both experts may be biased in favour of their client - bias, or at least intentional bias, is not as common a phenomenon as some may think – a more common problem is that, at least where an expert is briefed for and by each party, the valuers are provided with “selective information” and/or see an issue through the eyes of the party who is briefing them;

(vi) none of the above may apply and the experts may simply form different views on the same question as to “value” – this is commonly the situation where the facts are complex and there are considerable uncertainties involved. However, it can apply in even the simplest cases simply because valuation is not an exact science and involves issues of judgement – this aspect is considered further at paragraph 8 below.

Clearly, the potential for disagreement can be reduced in some (but not all) of these areas by better education and more rigorous standards.

8 THE “UNHOLY TRINITY” OF DISCOUNTS

8.1 There can be no question that valuation involves the exercise of judgement. That is not to say that the whole exercise is “judgemental”. Much of the debate about whether valuation is an “art” or “science” misses the point. There are “scientific” parts to the process – fact gathering, the application of mathematical processes eg discounting, multiplication, (as distinct form the choice of methodology) and so forth, - and areas involving judgment – typically assessment of risk and estimation of likely future outcomes. If the scientific part of the process is incorrectly applied the valuation is unsound. The valuer cannot simply say that the overall conclusion is a product of “professional judgement” and therefore not to be impugned. A difficulty facing the profession is to be able to demonstrate the distinction between the exercise of professional judgment, based on education and experience, and mere guesswork. Three core areas where this dilemma constantly arises are in the areas of selection of an appropriate capitalisation multiple or discount rate, and the application of discounts for lack of control and marketability. Consider:

53 See, eg, Energex Ltd v Elkington & Ors [2003] QCA 430 (3 October 1903)
Maxwell Hammer wishes to acquire the whole of the shares in The Local Small Carpentry Shop, which has a turnover of $500,000 and net profit of $100,000 per annum after tax and a fair salary to the proprietor, who is one of four employees. Rocky seeks the views of three valuers as to what the investment is worth. Each of the valuers applies a capitalisation multiple to adjusted earnings. The multiples are selected as follows

<table>
<thead>
<tr>
<th>Valuer A</th>
<th>Apply the capital asset pricing model having regard to the average betas of “comparable companies” (ungeared and then regeared to align with LSCS appropriate capital structure), risk free rate, market premium, size premia, specific risk adjustments, the cost of debt. Shows all calculations. The multiple is between 4 and 5.</th>
</tr>
</thead>
<tbody>
<tr>
<td>Valuer B</td>
<td>Take the average price earnings multiples of three building companies, add 30% control premium, deduct 50% of result for size, a further 20% for dependence on proprietor and 10% for other specific risks. Shows all calculations. The multiple is between 2 and 3.</td>
</tr>
<tr>
<td>Valuer C</td>
<td>List 15 matters taken into consideration (debt, dependence on proprietor, risk free rate, competitors, small size, unlisted, etc) and then states “having regard to these factors in my opinion the appropriate multiple is 3.5”</td>
</tr>
</tbody>
</table>

8.2 Here is not the place for an exposition of theory, with which most of us are, in any event, familiar. The issues are:

(i) are the first two exercises meaningful – is the result obtained a fair reflection of the multiple that an informed investor would pay and an informed seller would accept? Would an investor go through this exercise? Would he or she rely on an accountant who had done so? Is it what an investor should do whether or not he or she actually does it? Consider the words of Staughton J in Buckingham v Francis:

"Frankly I doubt whether businessmen are ruled by accountants when deciding how much to pay for a private company. They no doubt seek the advice of accountants beforehand, and are told the likely price/earnings ratio that would emerge from various different figures as the purchase price. And afterwards they are told, no doubt, what is the likely price/earnings ratio on the purchase price which they have decided to pay. But I wonder whether, in the crucial stage between, when they are deciding on a price, business acumen or hunch does not play a far larger part than the calculations of accountants."

(ii) are the first two exercises really just the same as the third - the valuer knows what answer he or she thinks is about right and is “justifying it” with some pseudo science;
(iii) how is one able to tell if Valuer’s C multiple is based on profound insights or is merely a guess?

(iv) if all three are really “guesses” how does one evaluate them? Is it simply a matter of examining the reports to try to assess the degree of understanding of the business/industry/valuation principles?

(v) why is it important to know the answers to these questions? What responsibility should a valuer have to disclose his or her reasoning? Is it impossible to explain how the answer was arrived at? Isn’t that what “professional judgement” is about? Certainly there is extensive judicial support for the proposition that valuation is not an accurate calculation but an estimate based on at least some discretionary elements which by their nature are not capable of “proof”, for example:

“there is ample authority to establish that valuations are not a matter of exact science and not infrequently mathematical calculations can produce an authoritative result which is in fact totally dependent upon bases which are not capable of mathematical demonstration”\(^{55}\)

“Valuation is a matter of estimation, not of precise mathematical calculation. It certainly involves the making of a value judgment in the metaphorical as well as the literal sense.”\(^{56}\)

But how does the client tell the difference between an “educated guess” and one that is “entirely ignorant”? The answer it would seem is to consider the professional qualifications and experience of the valuer. This begs the question “what are the appropriate professional qualifications”?

**Minority and marketability discounts**

8.3 Let us consider an example of what some might perceive as the use of the valuers pen as a magic wand. Consider:

Emily, Erica and Ethel Equine resolve to become property investors. Each subscribes \(20,000\) for shares in Erogenous Investments Pty Limited. The net asset value of the company three years later is \(600,000\). What is the value of Emily’s one-third share? Emily has obtained two valuations.

<table>
<thead>
<tr>
<th></th>
<th>Valuer A</th>
<th>Valuer B</th>
</tr>
</thead>
<tbody>
<tr>
<td>Company value</td>
<td>600,000</td>
<td>600,000</td>
</tr>
<tr>
<td>Pro rata value</td>
<td>200,000</td>
<td>200,000</td>
</tr>
<tr>
<td>Minority discount</td>
<td>180,000</td>
<td>160,000</td>
</tr>
</tbody>
</table>

---


\(^{56}\) Per Mason J (as he then was) in *St Helens Farm* (supra) at p4061
<table>
<thead>
<tr>
<th>Marketability discount</th>
<th>0%</th>
<th>40%</th>
</tr>
</thead>
<tbody>
<tr>
<td>Value of interest</td>
<td>$180,000</td>
<td>$64,000</td>
</tr>
<tr>
<td>Control premium C</td>
<td>25%</td>
<td></td>
</tr>
<tr>
<td>Minority discount = C/(1+C)</td>
<td>20%</td>
<td></td>
</tr>
</tbody>
</table>

8.4 It is not necessary to explain the concepts and their application to this audience. What is important is that the disparity in valuations in this degree is unfortunately not an isolated event in the litigation context. Of course, we have assumed that the valuers agree about the value of the underlying company – an unlikely outcome. Let us consider briefly where the discount numbers might come from.

**Control premiums and minority discounts**

8.5 The extent of any minority discount is often considered by reference to control premiums obtained in listed public company takeovers and is often taken to be of the order of 20% to 30%. Care must be taken to consider carefully what is the significance of such “control premiums”:

(i) a very significant component of such premiums is typically attributable to perceived post-acquisition synergies between the acquirer and the target. It cannot be assumed that there are always opportunities for such synergies in the public company context. Still less can it be assumed that any prospective buyer of the whole of a private company would necessarily be a synergistic buyer;

(ii) clearly not every listed company is routinely taken over. Most are not. If every listed company on a control basis was worth 20% to 30% more than the share price why are not more companies acquired?

(iii) At least some takeovers are “failures” with anticipated benefits to shareholders not being realised – there is an overpayment. How should that be allowed for, or doesn’t it matter?

(iv) the variation of control premiums paid is enormous and leads one to question the significance of any average. The following table shows "deal premiums" for all transactions over the last 5 full calendar years i.e. 2000 to 2004. The transactions were selected by including any transaction involving an Australian target or acquirer where pricing information was available. The deal premium is the acquisition price premium over the trading price 20 days before announcement of the deal.

**Summary of Control premiums paid 5 calendar years 2000-4**

<table>
<thead>
<tr>
<th>Range</th>
<th>Cumulative</th>
<th>Cumulative</th>
</tr>
</thead>
<tbody>
<tr>
<td>0-10%</td>
<td>52</td>
<td>52</td>
</tr>
</tbody>
</table>
8.6 The following propositions are posited:

(i) control is a continuum of degrees not an absolute – a holder of 100% of a company’s shares has absolute control, once there exist more than one shareholder control is shared. Some examples [figures are percentages] follow. The “disability” attaching to lack of control attaching to block of shares will tend to vary according to the size of the holding, and the size of the other shareholder’s holdings:

<table>
<thead>
<tr>
<th>Shareholders</th>
<th>A</th>
<th>B</th>
<th>C</th>
<th>D</th>
<th>E</th>
<th>F</th>
</tr>
</thead>
<tbody>
<tr>
<td>V</td>
<td>99</td>
<td>70</td>
<td>55</td>
<td>45</td>
<td>33</td>
<td>20</td>
</tr>
<tr>
<td>W</td>
<td>1</td>
<td>30</td>
<td>40</td>
<td>45</td>
<td>33</td>
<td>20</td>
</tr>
<tr>
<td>X</td>
<td></td>
<td>5</td>
<td>5</td>
<td>33</td>
<td></td>
<td>20</td>
</tr>
<tr>
<td>Y</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td>20</td>
</tr>
<tr>
<td>Z</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td>20</td>
</tr>
</tbody>
</table>

(ii) the sharing of control is not merely a matter of the rights set out in the Constitution but, depending on the purpose of the valuation, must take account of the antecedent understandings between the parties;

(iii) the family relationship of the parties and the expectations of shareholders may be relevant in Family Law proceedings – while there may be no present control there may be an expectation of future control;

(iv) In the listed company context the acquisition of control will often be accompanied by a reduction (often substantial) in the liquidity (marketability of the investment). If marketability has value (see below) then increased control reduces that value.

### Marketability discounts

8.7 Although valuers generally agree that something that is “marketable” (can readily be turned into cash) is worth more than the otherwise equivalent non-marketable asset there is no agreed basis for measuring the “discount” to be
applied. There are no generally available and accepted published data on marketability discounts in Australia. There are extensive and ongoing studies in the United States, which are sometimes quoted in Australian valuation reports. These must be viewed with some caution.

The United States Studies

8.8 US studies on marketability discounts in relation to minority parcels of shares in unlisted companies have generally focussed on two types of analyses. The first relates to studies of pricing of “letter stocks”, stocks identical to freely traded public company stocks except that there are restrictions in trading for a certain period. The second type of study relates to pricing in “pre-IPO” transactions, that is, dealings in shares in private companies which later became listed. The latter type of approach tends to be preferred because restricted stocks are certain to become tradeable while there is no certainty that a company will become listed.

8.9 There are two substantial ongoing studies on pre-IPO transactions conducted in the United States in relation to minority parcels. The first group of studies was conducted by John D Emory of Robert W Baird & Company. The studies found a mean price discount for the private transactions analysed (all occurring within five months of an initial public offering ("IPO") of 44% and a median of 43%, some 10% above those shown in the restricted stock studies57.

8.10 The second group of studies, conducted by Willamette Management Associates, relate also to pre-IPO pricing with some differences in methodology. The transactions analysed occurred from 1 to 36 months before the IPO with adjustments made for in each case for general movements in stock prices over the period58.

8.11 Pratt et al conclude59:

“The evidence from the Emory and Willamette Management Associate studies, taken together, is compelling. The studies covered hundreds of transactions over more than 20 years. Average differentials between private transaction prices and public market prices varied under different market conditions, ranging from about 40 percent to 63 percent, after eliminating the outliers.

This is very strong support for the hypothesis that the fair market values of non-controlling ownership interests in privately held businesses are greatly discounted from their publicly traded counterparts.”

58 Pratt, pp408-410.
59 Pratt, p 411.
8.12 The following propositions are posited:

(i) while it is tempting to appeal to the US studies as support for the application of very substantial discounts in the valuation of private company shares it is inappropriate to accept them blindly;

(ii) the pre-IPO studies suggest that shareholders disposing of heir interest less than five months before an IPO are willing to sell for 43% below the price at which the shares come to be listed. Why is this so? Given the time taken to bring a company to the market the seller must be aware of the imminent IPO and must have some idea of the likely selling price. Assuming the shares are not escrowed the IPO will bring liquidity. Would you advise your client to sell at that discount in those circumstances?

(iii) marketability also is a continuum and not an absolute “yes” or “no” proposition. 100% interests in any company are generally less marketable that an investment parcel of a liquid listed stock. Some substantial private companies have an organised (by the company) market for those (typically employees) wishing to buy or sell;

(iv) importantly, investments in shares in many private companies are not mere passive investments but are acquired in the context of an understanding which can (in some, but certainly not all cases) amount to what has been loosely called a “quasi partnership”. Again depending on the purpose of the valuation (and having in mind in particular the context of oppression and Family Law) ) the valuer needs to bear these considerations in mind before applying a substantial marketability discount;

(v) while everyone assumes that marketability is very valuable, the degree of the discount which “the man in the street” would apply might well be substantially less than a valuer would consider appropriate – see the example at paragraph 8.3 above. Would you advise Emily to sell her shares for $64,000. If the answer is “it depends”, on what does it depend and how should that factor be allowed for? Consider the following example:

Your great uncle Cholmondeley has left you an annuity for 10 years of $50,000 per annum on the basis that it is paid by the trustees on your birthday and the annuity ceases if you attempt to alienate it in any way (including declaring that you hold it in trust for another person) or mortgage it or in any way encumber it. The monies to meet the annuity have been set aside in Commonwealth bonds – assume for present purposes that there is no risk of non-payment. Does the annuity have a “value”? If it has no “fair market value” what sort of value does it have? If the fair market value assuming ready alienability is say $370,000 (ignoring tax) what is the “value” of the inalienable annuity?
9 VALUERS AND THE LAW

9.1 An issue facing valuers is the extent to which, if at all, they should have regard to the decisions of the Courts in determining the standard of value to be adopted and the approach to be taken.

9.2 While Spencer (supra) remains a cornerstone of “valuation law” it has been supplemented by a very significant body of case law dealing with valuation issues in a wide range of contexts. The cases (many decided in the context of death duty assessment in respect of shares in unlisted companies) decided over the intermediate period are gradually receiving less attention.

9.3 On one view, many of the principles of valuation derive from decided cases in which courts are called upon to decide the value of shares, a business, or some other asset. An alternative view is that the valuations are determined by the courts by giving recognition to and applying valuation principles and practices applied in commercial practice.60 A more extreme version of the latter view is that judges don’t act as valuers at all but only resolve disputes between litigants (or their valuer experts) as to value. Christopher Glover61 comments as follows on the relevance to valuers of judgements in decided cases dealing with valuation:

“Anyone who casually picks up a book on share valuation to obtain some idea of the subject would doubtless be intrigued by the way in which the dicta of learned judges are cited as the authority for almost every statement made. It is as if the art of valuation is to be learned by a careful reading of legal judgments. Yet the role of the judge is to apply the law in the settlement of a dispute, not to value shares. The judgments themselves show clearly that the judge does not regard himself as a valuer, but as a person appointed to settle a dispute as to value in the light of the expert witnesses’ evidence.”

9.4 Mr Glover goes on:

“Value concepts and valuation techniques do not have their origin in the court room but in the market place. It follows, therefore that anything a judge may say on a technical matter of valuation has no binding force on the share valuer nor should it set a precedent binding future cases…..”


9.5 In *St Helens Farm* Mason J [as he then was] made the following comments about the significance of judicial pronouncements dealing with valuation:

“…too much attention is given both by valuers and judges to what has been said by the courts in other cases on matters of fact and discretionary judgment, not being matters of law. Essentially valuations are estimations involving findings of fact and discretionary judgment made on the evidence given in an individual case. To apply slavishly the approach taken by a judge in another case, to apply the same discount or capitalisation rate that he applied, as if that rate had the force of a general rule, is to attribute to them the force that should be confined to propositions of law.”

9.6 It is submitted that the correct view depends upon the context in which the valuation is performed. It would seem that the issue is to decide when what a judge says is “a proposition of law” and when it is merely a finding of fact or the exercise of judicial discretion. It is submitted that the interpretation of the meaning of the term “value” or “market value” in a statute is a matter of law. Further, the determination of a court as to the basis upon which “value” should be determined in the context of applying a judicial remedy provided for in a statute, for example, a remedy for oppression in the context of the Corporations Act or the determination of value for the purpose of division of assets in the Family Court are, at least to a significant extent, matters of law. In such cases the principles laid down may contradict ordinary commercial practice. In these areas also, there is a strong view from the bench that it is the judge’s role to make the valuation, with or without assistance from the expert (or perhaps non-expert – see paragraph 2.4 above) valuers.

9.7 The following propositions are posited:

(i) the purpose or context of the valuation is always important in determining what the valuer should be doing;

(ii) where the valuation is for a “statutory” purpose (eg compulsory acquisition of shares under sec 667A of the Corporations Act, compulsory acquisition of land upon which a business is conducted, remedies for oppression, Family Law), then the objectives of the relevant legislative provisions and the interpretation of the provisions by the courts will have a bearing on the meaning given to the term “value” and also, possibly, to the valuation methodology to be applied (eg 667C of the Corporations Act);

62 *FC of T v St Helens Farm & Ors* 81 ATC 4040, at page 4062.

63 The Act (sec 664A) allows a 90% holder of shares to acquire compulsorily the balance of the issued shares on certain conditions. These provisions apply to all companies, and not only to listed companies or public (listed or unlisted) companies. One of the conditions is the provision of an expert’s report in relation to the proposal (Section 664C). The purchase is to be effected at a “fair value”. Section 667C of the Act sets out the approach to be adopted to determine the “fair value” of the relevant securities.
(iii) while the valuer should be aware of the decisions in the area relevant to particularly any “statutory” valuation, it is important to distinguish propositions of law enunciated in a case from the application of discretionary judgment in the particular factual circumstances of a particular case;

(iv) a valuer preparing a valuation in the context of litigation must be aware of the distinction between the basis of awarding damages in contract, tort (eg for deceit) and under the Trade Practices Act which may affect the basis on which the valuation is to be postulated. In particular, issues arise as to whether the business is to be valued on the basis that contractual representations had been correct, or is to derive its fair market value given what was actually known at the time, or its value using hindsight to impute “full knowledge” about the actual state of affairs at the relevant date, or the value amount which the buyer would have paid had a misrepresentation not occurred;

(v) even outside the “statutory” and litigation contexts there may be situations where there may be cases relevant to the approach to be taken to valuation, eg in the context of assessment of “fair value” by auditors in accordance with share transfer provisions;

(vi) even if what a particular court said in a case may be seen as a “proposition of law” that proposition may not be “binding” in another area of law. For example, the Family Court of Australia has generally held that minority interests in family companies are normally to be valued on a “value to the owner” basis. But this does not mean that the same principle will be applied in commercial litigation. Neither does it mean that a valuer should adopt that approach if asked to value the shares for the purposes of, for example, establishing bank security;

(vii) in general, in cases involving “non-statutory” valuations, the courts appear to simply try to follow commercial practices. However, it would be inaccurate to say that judges in such cases never perform valuations but only decide between competing submissions as to value;

(viii) the valuer considering the words of a judge in a particular case should have regard not only to what was said but how long ago it was said, in which jurisdiction it was said and the place of the relevant court in the hierarchy of that jurisdiction. For example, all other things being equal, a pronouncement by the High Court last week on a valuation issue is of considerably more significance than a decision on the same issue in 1950 by the English High Court (which is not the most senior appellate court in the English hierarchy).

64 See eg Holt & Anor v Cox (1997) 15 ACLC 645.
9.8 A review of decided cases can provide the valuer with a wealth of insights as to where one might obtain useful background information. If nothing else, such a review provides the valuer with examples as to how a range of different valuation issues have been approached, not only by judges but by counsel and accounting experts in a context where it has been necessary to carefully argue the validity of opposing approaches and methodologies. Whether or not one agrees with the outcome of any particular case is not as important as gaining an understanding of the issues arising and how one might go about addressing those issues.

10 THE RISKS AND REWARDS OF VALUATION PRACTICE

10.1 All of us have sufficient knowledge of the law of contract and tort, and of the Trade Practices Act to understand the risk of suit arising from the issue of a negligently prepared valuation report. There is a spectrum of risk in relation to valuation work. A valuer undertaking a valuation of company X in the context of litigation generally faces a lesser risk than the valuer providing an opinion on the value of the same company on which the client will rely to decide to buy it. Of course, if your client relies on a negligent and wrong valuation as the basis of settling a dispute that effectively involves the purchase or sale of the business, the position, on its face, may be much the same. Consider, for example, the position where you have advised a wife in Family Court proceedings that a company in which she has a 50% interest is worthless and she settles the matter (including the transfer of her shares to the husband).

10.2 The valuer acting as an expert witness has the benefit of several protections. Generally the client is not actually buying the business/company and the damages in a successful suit against him or her, if any, may be limited to the costs wasted (which, of course, may be substantial) in reliance on that wrong valuation. The valuer will have the benefit of the wisdom of an opposing expert who will generally explore alternative views and draw to the valuer’s attention “the errors of his ways”, giving the opportunity to withdraw or modify a deficient report. Witnesses are offered immunity in some circumstances and this may extend to reports prepared for litigation – the scope of this immunity is not entirely clear, particularly as regards the position where a report is prepared for litigation but the expert does not give evidence, because the matter is settled or the witness is not called.65

10.3 There have been significant moves to limit the liability of professionals. The passing of the legislation in various states66, combined with the passing of the Treasury Legislation Amendment (Professional Standards) Act 2004 (Cth) to

65 See, for example, Jovanovic v Woods [2001]TASSC 96; Stanton v Callaghan [2000] QB 75 in which was considered the position of an expert sued for agreeing to a joint experts statement in terms which the client thought detrimental to his interests.

66 For New South Wales see the Professional Standards Amendment Act 2004, given Royal Assent on 3 November 2004
overcome the obstacles placed in the way of limitation of liability by the Corporations Act and the Trade Practices Act, introduce a uniform scheme of capping of liability and allocate proportionate liability. However, the protection afforded by the legislation is subject to the holding of sufficient insurance cover, the implementation of risk management strategies, professional education and proper disciplinary and complaints procedures.

10.4 Insurance remains expensive. Risk is reduced by education. The failure to educate, and to promulgate and police standards will mean the risk of falling outside the protective legislative umbrella. But whether or not this is so is not the main issue. No professional wishes to be exposed to claims that his or her work is inadequate or negligent. Rather the professional wishes to be rewarded fairly for performing work to the best of his or her ability. It is to the benefit of all business valuers that standards be maintained at a high level to build respect in the financial community and minimise the adverse outcomes for all of us if fellow valuers are taken to task for shoddy work.

10.5 The financial rewards of valuation work are generally not overly generous for most of us. A significant part of the appeal for many lies mainly in the continual challenge to create some order in a world of kaleidoscopic uncertainties. Perhaps we have something in common with witch-doctors after all!

11 THE FUTURE: A VALUATION SPECIAL INTEREST GROUP?

11.1 What we need to support then is more structured education in valuation principles and practices and the promulgation of standards (or the adoption of appropriate international standards) by a new or existing body. The Institute is well placed to take on such a role. But many valuers are not members of the Institute and will never become members unless the Institute broadens its membership constituency. Whether or not that problem can be resolved, it would seem considerably easier to start with an established body with a significant number of valuers than to establish a new body. Having said that, Canada established a new body and the United Kingdom has recently also done so.

11.2 The ICAA convened on Wednesday 29th September 2004 a meeting to discuss the potential for the formation of a special interest group concerned with business valuation issues. An annexure to the invitation read as follows:

“The introduction of International Financial Reporting Standards and the advent of a number of market value-based pieces of tax legislation (eg tax consolidation) have meant that community requirements of the accounting profession in the area of valuation have increased substantially.

See the Civil Liability Act (NSW) sec 34 as regards proportionate liability.
As these developments are relatively recent, there has not yet been a coordinated response from the profession in relation to either how standards are to be developed and promulgated in this area or how practitioners are to be qualified.

It is recognised that a number of historical reasons for the conduct of valuation work will continue, including:

- Independent experts reports
- Disputes

However, the advent of the regulatory change about [sic.] will make the requirement for valuation literacy a much more central competency for practicing CAs and those in business.

A Special Interest Group in the area of valuation would support members seeking to develop themselves and the marketplace in this regard.

11.3 It would seem that the need for “valuation literacy” is not really a new phenomenon (see paragraph 4.1 above), although doubtless it has been exacerbated by the factors mentioned. In any event, at the December 2004 Board meeting of the National Council of the ICAA it was resolved that a Valuation Special Interest Group (“ValSIG”) be formed effective from 1 July 2005. Although there are no formal terms of reference yet adopted an attachment to the agenda of the meeting described above proposed terms of reference as follows:

“1 To provide technical expertise and formulate policy in relation to the accreditation of CA Business Valuers.
2 To assist professional valuers maintain high professional standards, increase awareness of issues impacting their clients and to provide advice and direction in responding to these issues.
3 To promote a better understanding of professional valuations within the accounting profession and with those groups that rely on the work of valuation experts such as tax advisors and senior management.”

11.4 It may fairly be said that it is much easier to identify a body of knowledge described as “valuation theory” than one called “forensic accounting theory”, the former perhaps being seen as a subset of the latter. It would seem that the feasibility of accreditation will not be the issue it has been with forensic accountants.

11.5 The decision of the Institute in this area can only be applauded. I make the following observations:

(i) chartered accountants undertaking valuations are a subgroup of large body of business valuers. Unless ValSIG (or whatever it evolves into) somehow becomes the sole source of accreditation and standard setting, and sets and enforces rigorous standards, we will continue to have the situation where non-CA valuers (some more qualified and some less qualified than ValSIG members) will be outside the purview of ValSIG. That is, whatever education requirements, valuation standards and disciplinary procedures ValSIG introduces will not apply to a large body of valuers – I understand in that regard that several non-CA valuers attended the first two meetings and that it I intended that anyone may become a ValSIG member. Of course, voluntary membership and adherence to standards may be a useful first step but it seems unlikely that all non-CA valuers will join;
(ii) what we don’t need is to reinvent the “standards wheel”. The IVSC has high quality standards, as do other bodies. In this age of internationalisation, it would, in my view, be short-sighted to adopt different standards and guidelines unless there are some very pressing reasons for doing so. It is unlikely that such reasons exist given that the principles of valuation are universal;

(iii) whatever accreditation mechanism is adopted must carry credibility – mere membership of a “special interest group” is not enough.

11.6 It would seem then that, in an ideal world, the Institute, in conjunction with CPA Australia, the SIA, and possibly other relevant bodies, should move towards forming an autonomous or partly-autonomous body of business valuation professionals, comprising members and non-members of the ICAA, which would consider adopting “state of the art” international standards, implement training and introduce formal accreditation based on education and experience.

11.7 Society’s expectations of professionals are continually increasing. It is obvious that the introduction of valuation standards, accreditation and more rigorous education cannot happen overnight. However, the very significant changes that have happened in forensic accounting, including the constituting of FASIG and the achievements (including this conference) of that body, the extensive development of expert witness rules [which may soon (hopefully) be standardised across Australia], and the introduction of forensic accounting training programmes by Wollongong and Monash Universities, show what can be achieved in a very short space of time.