

THE VALMIN CODE - BIBLE, ROADMAP OR SIGNPOST?

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INTRODUCTION

Perceptions of the objectives and implementation of the VALMIN Code vary widely within the mineral industry, and there is some divergence of views even among members of the VALMIN Committee itself. Some see it as a definitive rulebook for preparation of reports, with any infringements providing clear grounds for disciplinary action by their professional institute, while others see it as a compelling manual of practice to assist practitioners in preparing reports of the highest possible quality.

The views I express here, must therefore be taken as mine alone, and not reflecting an “official” position of the VALMIN Committee.

Whatever the differences in approach among the committee members, there has been total agreement that a code was urgently needed to raise the professional standard of valuation reports prepared by independent experts in compliance with Stock Exchange listing rules and the Corporations Law.

Although most published reports were professionally and competently prepared; a minority were clearly misleading whether from incompetence, lack of care, or excessive effort to satisfy client’s wishes. There was often a wide variation in what authors thought necessary to include by way of explanation as to how they had arrived at their valuations and opinions. We have gone beyond the stage where the opinion of an expert given in a report is accepted purely on the strength of his professional reputation. Readers have the right to know the bases for an expert’s opinion and should, where possible, be given sufficient information to make their own judgement if they so wish. Disciplining of errant AusIMM members has been difficult, however, because of the necessarily judgemental elements in valuations, and the lack of any written guidelines or rules.

Initially, the Committee thought in terms of preparing a comprehensive “bible” of valuation practice, and sub-committees were set up to determine acceptable (and unacceptable) valuation methodologies, etc. It soon became clear, however, that because any valuation is a matter of opinion, and particularly so in the case of an untested exploration prospect, no set valuation methodology can be prescribed. The expert doing the valuation must be able to decide how best to arrive at an appropriate value. The emphasis therefore changed to defining the essential framework and features that should characterise a professional and competent report. Throughout the long gestation period of the Code, there were endless arguments on which elements were or were not essential, and which should be mandatory rather than recommended, as ultimately reflected in the Code by the use of the words ‘must’ and ‘should’.

In its current form as published, the Code reflects a mixture of consensus and compromise, glued together by the overriding concept of materiality. In other words, it can be looked at as being a roadmap to help the practitioner avoid the traps and pitfalls and use his judgement in choosing the best route to reach his objective. To continue this analogy, he must, however, still observe the traffic lights, which are clearly marked on the map. The Code is therefore more than a simple signpost.

The importance of materiality cannot be overemphasised. Without its observance, a valuation report could be prepared in strict conformity with the Code and would satisfy all the requirements of the ASX, ASIC and the AusIMM Ethics Committee, but would still be of little use in providing practical guidance to its readers, especially to non-professional investors.

The Code will therefore only be effective if all practitioners interpret its provisions intelligently in the context of each specific situation. In doing so, they must, of course, be prepared to justify their interpretation if called upon.

It has always been accepted by the Committee that the scope and format of a report will need to be tailored to the circumstances, whereby the cost of preparation never becomes disproportionate to the

value of the assets in question. It would obviously be absurd to spend tens of thousands of dollars on a highly detailed report on an asset worth only a few thousand, and where the assets concerned represent only a small proportion of the total assets of a company.

OBJECTIVES OF EXPERT REPORTS

While fully accepting the importance of the Code as a means of minimising the number of unprofessional and misleading valuations, I am more interested in how it can assist us all in our drive for increased excellence in reporting.

Which brings me to the main point I wish to put to you, one that is not specifically addressed in the Code. What should the overriding objective be in preparing any valuation or expert report and how does the practitioner meet such an objective while satisfying the requirements of the Code?

In my view, the answer to the first part of the question is quite simple, although the answer to the second part is anything but!

The essential characteristic of all reports falling under the Code, that is reports prepared under the Corporations Law or ASX Listing Rules, is that they must be capable of being relied on by the shareholders or potential investors to whom the report will be distributed or made available to. More importantly, the Corporations Law makes it clear that particular consideration must be given to the non-professional investors, who must be assumed to lack the technical and financial expertise of professionals, such as brokers and institutional investors.

I have suggested already that the intention of the Code is to provide a roadmap, which if followed, will go a long way to satisfying this objective. To switch metaphors, the Code is like most cooking recipes, in that slavish adherence will usually produce a result that is edible, but not one that most people would pay good money for in a restaurant. Most of us would prefer to be thought of as the equivalent of a first-class restaurant, rather than as a MacDonaldis or a KFC! I therefore argue that the practitioner must interpret and follow the Code intelligently and with common sense, using experience to refine the recipe so that the result is both digestible and nutritious, keeping in mind at all times the likely needs of the reader in having to reach a decision on the proposition being reported on.

In other words, the results have to be genuinely useful to the reader. This is the absolutely essential ingredient of a truly professionally written report. It is also not always easy to achieve. Indeed, most of us can look back at our past work with mixed feelings, realising in hindsight that we could have done better in some cases but proud of the results in others.

There are two particular points that I believe must always be kept in mind when preparing reports. The first relates to the distinction between professional investors, who can be deemed to have the expertise to form their own conclusions if provided with the essential information, and non-professional investors, whom it can be assumed will rely heavily on the conclusions of the expert. Any report competently prepared in strict conformity with the Code can be expected to meet the basic requirements of the professional investors, who are most concerned with the Code's provisions for completeness and transparency. In contrast, such a report might not necessarily be effective in communicating to the lay reader the information he needs in making a decision unless care is taken to present the conclusions in a meaningful and understandable manner.

More importantly, another difference between the two classes of investors is likely to lie in their respective investment philosophies, as institutional investors often make decisions on distinctly different grounds from those of private investors, and each type will therefore tend to look for different information in a report. Amongst other considerations, it is probably true to say that private investors are more likely to take a longer-term view than the institutions, which are more commonly traders driven by short-term performance goals.

This distinction can be particularly relevant with respect to exploration properties. These may be perceived as having little value by an institution, particularly if the timeframe for likely discoveries is more than a year or two away. The private investor, in contrast, may be prepared to hold on for the prospect of ultimately making a substantial capital gain, and will rely heavily on the Expert's views on prospectivity. The preparation of valuations of exploration properties in a manner that genuinely satisfies the needs of multiple classes of investors can therefore present real problems, particularly in the context of a Part B

Statement valuation. There are examples of recent Part B valuations which were heavily criticised and even ignored by institutional investors, who considered, at least in part, that too much value had been placed on exploration potential. It may very well have been the case, however, that the existing small shareholders, and even the offeror, were much more comfortable with the valuation.

In addressing this issue, I suggest that the following aspects be taken into consideration:

- The distribution of shareholdings in the share registry. Different approaches to a report may be needed when a company has a preponderance of long-standing small shareholders (e.g. Oil Search), as opposed to a relatively few, mainly institutional shareholders (e.g. Novus).
- The bases for preparing a valuation range (i.e., high to low).

This should be carefully thought out, as it can be used as a mechanism for addressing the needs of different classes of investors. Too often, one sees ranges of values without any attempt to explain what they are meant to represent, and great care should be used in stating a 'preferred value', unless it is clearly indicated why that particular value has been selected.

The second issue I wish to address relates to the importance of balance in a report. One can mislead the reader in more ways than simply by making false statements or omitting key data. Inclusion of excessive detail can easily be misleading by implying an undue emphasis on a particular element of a valuation or evaluation. For example, most of us accept that quantitative valuations of exploration properties have limited validity, however sophisticated the numerical techniques used in obtaining a result. It can be difficult at the best of times to explain to the lay reader (or, in some cases, even to the professional analyst) that such numbers should be treated with great caution, and not thought of as absolute truth. It is human nature, however, to instinctively put more reliance on the results of a complex mathematical calculation (particularly computer output) than on what is clearly a subjective estimate based on professional judgement and experience, and for which the expert himself may find it difficult to provide a rigorous explanation.

Inclusion of too much detail, in an earnest attempt to meet the transparency requirements of the Code, can therefore be effectively misleading by making a report unbalanced. It must not be forgotten that any valuation of an exploration property rests almost entirely on the geological evaluation, not on numerical manipulations, which are really only a form of notation for the perceived risk and reward.

This issue of the ratio between risk and reward is one which is fundamental to any evaluation of exploration properties, but is so often overlooked or inadequately addressed in reports. Most investors are less interested in some estimate of the "value" of a property, than in obtaining a feeling for the likelihood of a discovery, and of how much it could be worth. The relative values of two properties, one of low risk and low reward and the other of high risk and reward, will vary significantly between different investors with divergent risk/reward investment criteria.

PROTECTION OF CONSULTANTS

I turn now to a completely different aspect of the Code. I believe that many practitioners have a jaundiced view of the Code, not because they are incompetent, lazy or dishonest, but because they see it as another example of unnecessary and proscriptive regulation which makes life more difficult, while providing them with no apparent benefits. Some also are worried that it exposes them to new liabilities, if they should inadvertently breach the Code in any way.

The Code, however, provides all consultants with a very practical level of protection which has previously been completely lacking. Individual consultants in particular, have always been in an extremely weak bargaining position with respect to their clients. When work is scarce, it has been very difficult for a consultant to insist on proper contractual documentation prior to commencing work, and even more difficult to resist pressure for amending a report with the threat of withholding or delaying payment hanging unsaid in the background. More importantly, many companies look at expert reports as an unnecessary expense (or worse), and resist the budgets required for the preparation of a report that fully meets the requirements and intent of the law.

The Code, however, *requires* the consultant to obtain certain assurances from the client in advance, and provides a powerful weapon in withstanding any pressure for producing superficial or 'quick and nasty' reports that clearly do not meet the requirements of the Code. The Code places a legal obligation on the client by requiring those assurances to be made as written declarations by the commissioning entity, and provides a significant level of protection to the consultant. I am not suggesting, of course, that all of the client/consultant problems magically disappear, but at least the battle becomes a little less one-sided.

Nevertheless, it is incumbent on consultants to institute proper procedures to ensure that they are protected as far as possible. In my company, we have addressed the issue by having standard Terms of Engagement, which are made part of any proposal or contract. In addition to the normal commercial provisions, the standard terms include specific clauses whereby the client makes the undertakings required under the Code, and also bind the client not to use or publish any reports in part or whole without our written approval.

CONCLUSION

In conclusion, I would like to say that I do not believe there can ever be a consensus on valuation methodology, or on how considerations of materiality should be used in implementing the Code. I do not think this matters particularly, and at least it reflects the fact that, on the whole, there are very few sheep in our profession, we work in an industry where original thought is at a premium.