



INTERNATIONAL VALUATION STANDARDS COUNCIL

Valuation of Liabilities

DISCUSSION PAPER

Comments on this Discussion Paper are invited before 30 April 2013. All replies may be put on public record unless confidentiality is requested by the respondent. Comments may be sent as email attachments to:

CommentLetters@ivsc.org

or by post to IVSC, 68 Lombard Street , LONDON EC3V 9LJ, United Kingdom.

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Background to this Discussion Paper

The Introduction to the International Valuation Standards (IVSs) states that the standards apply to the valuation of both assets and liabilities. The definition of Market Value in the IVSs specifically includes liabilities in addition to assets. However, there is no definition of what constitutes a liability, and little consideration of any characteristics or attributes that are specific to liabilities as opposed to assets.

Preliminary investigations by the Board have established a lack of guidance specifically relating to the valuation of liabilities. Within the field of financial reporting, the IASB's IFRS 13 *Fair Value Measurement* specifically includes liabilities within its scope, but stipulates that specific assumptions be made that are directed at achieving a consistent accounting measurement of liabilities. Some of these assumptions, eg that a transfer has to be assumed even where fulfilment or cancellation are more likely or that in the absence of quoted prices a liability is to be valued from the perspective of the counterparty holding the corresponding asset, may or may not be appropriate when establishing the value of a liability for purposes other than financial reporting. The Board therefore considers that there is a need for standards or guidance on the valuation of liabilities in a wider context.

In 2010, the IASB issued an Exposure Draft¹ which proposed certain amendments to the existing IAS37 *Provisions, Contingent Liabilities and Contingent Assets*. The responses received to this draft illustrated a significant diversity of opinion, not only on when a liability should be recognised in a financial statement but also how it should be measured, ie valued. The IASB's liabilities project is currently paused as priority is being given to those projects identified as being important in achieving the convergence of IFRS and US GAAP.

The IVSC Standards Board has therefore agreed that a dedicated project is required to determine appropriate valuation practice for liabilities [other than those arising from financial instruments] and develop as necessary a dedicated standard and supporting technical guidance.

This Discussion Paper is the first stage of the project. It sets out a number of issues that the Board has identified and invites responses from all those with an interest in valuation of liabilities, including, valuation providers, liability holders, investor groups, professional bodies and those with a regulatory role that is impacted by valuation.

¹ IASB ED/2010/1

Notes for respondents:

In order for us to analyse and give due weight to your comments please observe the following:

1. Responses should be made in a letter format, where appropriate on the organisation's letter heading.
2. Comments should not be submitted on an edited version of the Discussion Paper.
3. Unless anonymity is requested, all comments received may be displayed on the IVSC website.
4. Comments letters should be sent as an e mail attachment in either MS Word or an **unlocked** PDF format and no larger than 1mb. All documents will be converted to secured PDF files before being placed on the web site.
5. The e mail should be sent to commentletters@ivsc.org before 30 April 2013

Key Definitions and Concepts

1. Although liabilities are referenced in the IVSs there is no current definition of a liability nor any specific standard or guidance relating to the valuation of liabilities except for financial liabilities that arise under the terms of a financial instrument. It is the preliminary view of the Board that a definition for liability would be helpful in developing any future standard or guidance on this topic.
2. For the purpose of this Discussion Paper the holder of a liability is any party that has an obligation that may be measured in monetary terms to another party or parties. The beneficiary is the party or parties to which the obligation is owed. The obligation may be a single event or a series of events.
3. A liability may arise between the holder and beneficiary specific under contract or law. In certain cases it may also arise from custom, ie it is implied by actions taken by the holder.
4. Having regard to the above, a possible definition for a liability in a future IVSC standard or guidance could be:
An obligation which could result in an outflow of resources.
5. A liability can be extinguished in a number of ways. It may be fulfilled by the holder making the required payment or taking the required action. It may be transferred to a third party who accepts the liability in return for a payment. It may be settled, offset or cancelled through an agreement between the holder and the beneficiary. These all indicate different valuation approaches and are discussed later in this paper.
6. A liability may be an obligation to pay a cash amount, but may also take other forms, eg
 - to take a specified action, eg restoring or reinstating an asset,
 - to transfer non cash assets,
 - to provide a service or
 - to replace with an alternative obligation.

The common factor is that all involve the consumption of economic resources held by the holder of the liability. Unless it is expressly stated otherwise, in the remainder of this paper references to the cost of extinguishing a liability is the either the cash amount required or to the monetary equivalent of any non cash resources required to meet the liability.

Questions

- 1 **Do you agree with that the IVSC should produce a standard or guidance on the valuation of liabilities as defined above? If not please explain why.**
- 2 **Do you agree that the possible definition of a liability given above is both clear and adequate? If not any alternative suggestions would be welcome.**

Project Scope

7. The preliminary view of the Board is that not all liabilities should be within the scope of a future standard or guidance. The perceived valuation problems tend to be around the valuation of liabilities that are not a defined payment on a specific date or dates in the future.
8. Accordingly it is proposed that obligations to pay defined sums arising under a contract such as payments under a lease be excluded. For the same reason it is proposed that deferred tax liabilities be excluded.
9. Some liabilities have distinct characteristics or are the subject of existing or proposed standards and guidance. Financial instruments², pension liabilities and insurance liabilities fall into this category and it is proposed that they be excluded from the scope of this project.
10. This means that the proposed focus of the IVSC's project will be on the valuation of liabilities where the cost of the obligation is not defined. Examples include:
 - contractual liabilities to repair or restore an asset,
 - product warranties,
 - asset retirement obligations,
 - delivery of goods or services for which prepayment has been received and other performance obligations and
 - statutory or other non-contractual obligations, e.g. site remediation or decontamination obligations imposed by law.
11. Some liabilities other than those arising under a financial instrument are contingent on a future event. Typical examples include:
 - a contract for the transfer of a business may provide for the buyer to pay an additional sum to the seller if a specified revenue or profit target is reached within a stated period.
 - A contract for the transfer of the asset may provide for the buyer to pay an additional sum to the seller upon the future grant of a permission or license by a statutory authority.

Although the buyer's liability arises under a contract and the sum is known it differs from other contracted payments because it is conditional on a future event, which presents a particular

² In IVS 250, a financial instrument has been defined as "a contract that creates rights or obligations between specified parties to receive or pay cash or other financial consideration, or an equity instrument. The contract may require the receipt or payment to be made on or before a specific date or be triggered by a specified event. An equity instrument is any contract that creates a residual interest in the assets of an entity after deducting all of its liabilities."

valuation challenge. The Board is interested in views on whether such contingent liabilities should be included in the scope of the project.

12. A further category of liability is one arising in relation to legal proceedings that are current or impending at the valuation date. Some argue that while a defendant might allow for a reserve or provision to cover the possibility of having to pay the damages and costs this is not intended to represent a “value” of a liability. While a valuation might be required to support or defend a claim, this is not a measure of the defendant’s liability on any given date. They point to the fact that a large proportion of litigation is settled by negotiation and in reaching a settlement the parties have regard to many factors other than the value that might be ascribed to the loss suffered by the claimant. Accordingly, suggesting that valuation techniques can be applied to measure a liability that is contingent on so many unknown factors is unrealistic and that litigation liabilities should not be included in the scope of the IVSC’s project.
13. Others argue that valuations are produced for assets and other types of liability that are contingent on future events and that potential litigation liabilities are no different and should be included in the project.

Questions

- 3 Do you agree with that liabilities arising under a financial instrument should be excluded from the scope of this project?**
- 4 Do you agree that other liabilities such as rental payments, pension liabilities, insurance liabilities and deferred tax should also be excluded?**
- 5 Do you consider that contingent liabilities as described above should be included? Please also indicate if there are any other types of contingent liability that should be included.**
- 6 Please indicate whether you believe potential litigation liabilities can or should be valued and whether they should be included in this project.**

BASES OF VALUE

14. The IVSs define a basis of value as a statement of the fundamental measurement assumptions of a valuation. It defines the objective of the valuation assignment.
15. The IVS Framework identifies three principal categories into which a basis of value can fall. First is the most probable price that could be obtained in a hypothetical exchange in the market, second is the value or benefit that a specific party can derive from ownership and third is a price that would be reasonable between two specific parties having regard their respective positions. Market value,

investment value, special value and fair value³ are bases defined in the IVS Framework in each of these categories. The Board considers that the concepts underlying these three categories can all be used when valuing liabilities. For example:

- Market Value represents the price which a holder of a liability would have to pay to transfer the liability to a third party in the market.
 - Investment value represents the cost to a holder of fulfilling the liability. This may differ from the price that they would have to pay to a market participant to accept a transfer.
 - Special value represents an incremental amount over and above the market value that holder with a special interest in extinguishing the liability would pay.
 - Fair value represents the price that a holder of the liability would have to pay to settle the liability with a specific party. It may differ from market value, for example where the transferee had a special reason for accepting the liability that was not shared by market participants in general.
16. These bases are not mutually exclusive. For example while for certain liabilities the cost under each of the four bases outlined could differ, under other circumstances the cost of transfer to a third party market participant may be the same as the cost of fulfilment or settlement.
17. The definitions of these bases included in the IVS Framework are reproduced as Appendix 1. The Board believes that it may be necessary to produce either modified or alternative definitions to enable the concepts to be more readily applied to the valuation of liabilities. For example, the “entity specific” basis of Investment Value is the value to an owner for individual investment or operational objectives, which may not capture the criteria by which a holder of a liability would determine the value to it of extinguishing the liability.
18. The appropriate basis of value is determined by the purpose for which the valuation is required. For example market bases such as IVS market value or IFRS fair value will normally be required for financial reporting. Investment value is appropriate when a holder is examining the cost to itself of holding a liability which may useful to inform management decisions. Fair value would be appropriate where two counterparties are considering a settlement that takes account of their specific circumstances.
19. The bases of value should not be confused with the method used to estimate the value. Although some methods may be more appropriate for some bases than others, the same methods may be used with different inputs to estimate the value on different bases. Methods are discussed in the next section.

³ This is not the same notion as IFRS Fair Value which is a market basis.

Questions:

- 7 For what purposes are you aware of liabilities being valued?**
- 8 What basis or bases of value do you normally encounter?**
- 9 Do you agree that the bases that are appropriate objectives for a valuation of liabilities fall within one of the three categories described in the IVS Framework?**
- 10 Do you agree that it may be necessary modify some of valuation bases definitions in the Appendix in order for them to be applied to liabilities as opposed to assets? If so it would be helpful to indicate any changes you believe appropriate**

Valuation Methods - General

20. The IVS Framework identifies the three principal valuation approaches, the Market Approach, the Income Approach and the Cost Approach. Within each approach, there are various methods that have evolved and that are used to a greater or lesser extent for different types of asset/liability or in different markets. The Board believes that all three approaches are applicable to the valuation of liabilities.
21. As indicated in section 1 a liability can be extinguished by a holder in a number of ways. It can be fulfilled, transferred to a third party or settled with the beneficiary. Different methods can be used to replicate these different scenarios. As in the case of assets, it is often prudent to use more than one method to estimate the value of a liability, although not all methods will be appropriate or applicable to all scenarios.
22. Except for the special circumstances or requirements under accounting standards which are discussed later, a holder of a liability would rationally seek to mitigate or eliminate a liability to the greatest extent possible. This would mean that the holder would adopt the lowest of the costs involved in fulfilling, transferring or settling the liability.
23. While fulfilment is normally an option under most scenarios, transfer or settlement does require a willing counterparty or market participant. For some types of liability there may be no market into which a transfer could be negotiated at any price, thus meaning methods that are predicated on transaction data have no relevance. Settlement would require agreement with counterparty, a situation that would not exist in the case of a statutory liability.

Market Approach

24. The Market Approach provides an indication of value by comparing the subject liability with identical or similar liabilities which are actively traded and for which price information is available. If financial instruments, insurance and pension liabilities are excluded (see section 2) there are few liabilities for which an active market exists and for which price information is available.
25. The Board believes that the market approach has little application to the valuation of liabilities falling within the proposed project scope, although would be interested to learn of any liabilities that are traded in an active market and to which it can be commonly applied.

Question

11 If you have experience of using the market approach to value liabilities, please indicate the nature and types of liabilities where this is used.

Income Approach

26. The Discounted Cash Flow method is a very common method under the Income Approach and has many detailed variations. The IVSC's TIP 1 *The Discounted Cash Flow Method*⁴ provides guidance on the principles involved in building a cash flow model. The Board is interested in exploring the diversity that exists when this method is applied in the valuation of liabilities in order to identify where supplementary guidance may be appropriate.
27. The Board is interested in learning which inputs are commonly used in projected cash flows to fulfil, transfer or settle the underlying liabilities.
28. The Board is aware that there is significant diversity in the approach adopted for deriving the discount rate when applying a discounted cash flow method to the valuation of a liability. IVSC TIP 1 *The Discounted Cash Flow Method* indicates that the discount rate should reflect the time value of money and the relative risks associated with the cash flow. Those risks are comprised of market (or systematic) risks and asset or entity specific risks. The discount rate also has to reflect the nature of the cash flows to which it is being applied. Some apply these principles to the value of liabilities.
29. However, many argue that when valuing a liability the systematic and market risks that are associated with a corresponding asset are of little or no relevance. Whereas an increased risk to an investor in an asset is rewarded by an increase in the required return and a corresponding reduction in the capital value, an increase in the risk associated with a liability should increase the negative value of the liability, not decrease it. Also, the risk faced by a holder of a liability is that the cost of fulfilling the liability when it becomes due exceeds the sum set aside to meet it and is correlated with the nature of the liability rather than the nature of the asset. For example, the risk associated with

⁴ Published by the IVSC in July 2012. ISBN 978-0-9569313-4-4

accepting a sum today to reflect future cost of remediating a contaminated industrial site is correlated with the risks associated with the contamination and the procedures necessary for its remediation, not with the risks associated with investment in uncontaminated industrial land. For this reason it is argued that the risks associated with a liability are often better reflected in the cash flows than in the discount rate.

30. The Board is also interested to learn of the extent to which techniques such as option pricing and Monte Carlo simulation are used to estimate the current value of liabilities which are dependent upon uncertain future events.

Questions:

- 12 Please give an example of a type of liability where you have encountered or used a DCF method and indicate the purpose for which the valuation was required.**
- 13 For the example given for question 12, please indicate the source of the projected financial information used in the cash flow forecast.**
- 14 For the example given for question 12, indicate what risk factors you reflected and whether these were reflected by probability weighting the cash flows or the discount rate.**
- 15 Do you consider that a “risk free” rate should be used when estimating the current value of a future liability? If not please indicate how you derive the rate and the rationale to support it.**
- 16 Please indicate if you have used or encountered option pricing in estimating the value of liabilities. If so please indicate the nature of the liability and the purpose for which the valuation was required.**

Cost Approach

31. The Cost Approach can be applied in the valuation of assets when there is either no relevant transactional data that can be applied to use a Market Approach or no sufficiently reliable income projections to use an Income Approach.
32. The IVSC’s TIP 2 The Cost Approach for Tangible Assets⁵ describes the common application and methods used under the Cost Approach. This guidance is not applicable to liabilities. For a liability there is no symmetrical concept to the modern equivalent asset discussed in TIP 2, and neither would a liability be depreciated, ie reduced, for physical, functional or economic obsolescence.

⁵ Published by the IVSC in March 2012. ISBN 978-0-9569313-1-3

33. One inconsistency that has been brought to the Board's attention is whether an allowance for a "profit margin" for the holder should be included in the calculation of the costs of fulfilling a liability. This allowance should not be confused with the profit margin that would be expected by any contractor undertaking work required to fulfil the liability and which would be reflected in contractor quotations. Those who support such an allowance contend that any party taking on a future liability would need to reflect the risk of current cost estimates proving insufficient when the liability becomes due. Others argue that a holder of a liability would not seek to include a profit margin in the valuation of the liability as this would have the effect of increasing the liability and thus reducing actual profit in the holder's business.
34. The cost of fulfilling a liability may be a direct indication of its value or an input into another approach or method that may be used for measuring a liability, whether it is to be actually fulfilled or transferred, settled or cancelled. The Board is interested in any methods or techniques used under the Cost Approach for valuing liabilities within the scope of this project.

Questions:

- 17 Please indicate whether you agree that in calculating the value of a liability based on the cost of fulfilment at a future date a "profit margin" (or risk premium) should be included to reflect the risks to the holder of the cost estimate proving inadequate. If so, please give an example.**
- 18 If you use or are familiar with the Cost Approach, please indicate in your experience how the cost of fulfilling, transferring or settling/cancelling an equivalent liability is determined.**

Valuations for Financial Reporting

35. IVS 300 Valuations for Financial Reporting is applicable to all accounting standards. However, the guidance on the valuation approach for various different accounting purposes references the International Financial Reporting Standards (IFRSs) and this discussion paper follows the same convention.
36. Under IFRSs liabilities of uncertain timing or amount are accounted for applying IAS 37 *Provisions, Contingent Liabilities and Contingent Assets*. Liabilities that are within the scope of other standards, eg financial instruments, insurance contracts, leases and pensions are outside the scope of IAS 37. Although at first sight the scope of IAS 37 and the proposed IVSC project are similar, the IVSC project is addressing the valuation of liabilities for any purpose and is not addressing only the requirements in the IFRSs.

37. The proposed definition for a liability is different from that defined within the IFRS *Conceptual Framework for Financial Reporting* (Paragraph 4.4) as “a present obligation of the entity arising from past events, the settlement of which is expected to result in an outflow from the entity of resources embodying economic benefits.” Within the accounting regime there are recognition criteria that have to be met. In other words, not all the liabilities covered by the IVSC project would be recognised in the financial statements.
38. Not all liabilities that have to be recognised in financial statements prepared under IFRSs are required to be valued. However, any liability acquired in the course of a business combination has to be measured at its fair value as defined in IFRS13. The fair value definition in IFRS 13 is based on a transfer of the asset or liability. Para 34 provides that the required assumption is that the liability would remain outstanding and the market participant transferee would be required to fulfil the obligation. The liability would not be settled with the counterparty or otherwise extinguished on the measurement date.
39. IFRS 13 also states that when a quoted price for the transfer of an identical or similar liability is not available and the identical item is not held by another party as an asset (often the case for liabilities within the scope of IAS 37) that the value can be estimated by taking into account the future cash outflows that a market participant would expect to incur in fulfilling the obligation, including the compensation that a market participant would require for taking on the obligation.
40. In view of the provisions of IFRS 13 and the guidance it contains on applying its principles to liabilities that are required to be measured at fair value under other IFRSs, the Board does not consider that its project should address the valuation of liabilities specifically for financial reporting. However, it is recognised that this is the most common purpose for which liabilities are required to be valued and therefore it is proposed that future guidance should summarise the requirements under the IFRS and relate them to the general valuation guidance proposed by the IVSC.

Questions:

19 Do you agree with the Board’s proposed approach?

Bases of Value Definitions in IVS Framework:

Fair Value

The estimated price for the transfer of an asset or liability between identified knowledgeable and willing parties that reflects the respective interests of those parties.

The distinction between this definition and the IFRS 13 definition of Fair Value used in financial reporting is discussed in the IVS Framework paras 39-43 and IVS 300, paras G1-G2

Investment Value

The value of an asset to the owner or a prospective owner for individual investment or operational objectives.

Market Value

The estimated amount for which an asset or liability 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.

Special Value

An amount that reflects particular attributes of an asset that are only of value to a special purchaser. (see below)

Special Purchaser

A particular buyer for whom a particular asset has special value because of advantages arising from its ownership that would not be available to other buyers in a market.