THE
HONG KONG
ASSOCIATION
OF
BANKS
香港銀行公會

Room 525, 5/F., Prince's Building, Central, Hong Kong
Telephone: 2521 1160, 2521 1169 Facsimile: 2868 5035
Email: info@hkab.org.hk Web: www.hkab.org.hk

ilttf:1Jft:*:T-:k&15:fm5251¥:
m ' 2521 1J6o, 2521 1169 lllxrtl4 , 2868 so35
'iiltll : info@hkab.org.hk :1.!1: : www.hkab.org.hk

28 March 2013 By email: CommentLetters@ivsc.org

lnternational Valuation Standards Council
41 Mo01·gate
LONDON EC2R 6PP
Uruted Kingdom

Dear Sirs

IVSC Discussion Paper: Valuation of Liabilities

We refer to the Discussion Paper of the International Valuation Standards Council on Valuation of Liabilities.

Our comments on the discussion paper are attached. Should you have any questions, please do not hesitate to contact our Senior Business Manager Ms Caris Wan at 2521 1855.

Yours faithfully

Boey Wong
Secretary

Enc.

Response of the Hong Kong Association of Banks ("HKAB") to the Specific Questions in the International Valuation Standards Council's ("IVSC") Discussion Paper: Valuation of Liabilities

Question 1

Do you agree that the IVSC should produce a standard or guidance on the valuation of liabilities as defined above? If not please explain why.

We agree that the IVSC should produce a standard or guidance on the valuation of liabilities other than those that meet the definition of a financial instrument, which are separately addressed in IVS 250 *Financial Instruments.* The Board notes that there is a need for standards or guidance on the valuation of liabilities in a context wider than financial reporting. We understand and support the Board's efforts in this regard; however, we believe that financial reporting requirements must be included as part of that wider context.

We note that not all liabilities recorded for financial reporting purposes are measured at fair value under IFRS 13 *Fair Value Measurement,* for example:

> IFRS 2 *Share-based Payment* and lAS 17 *Leases* are both specifically excluded from the scope of IFRS 13. Therefore, references to fair value in those standards are defined by those standards and not the definition in IFRS 13.
>
> lAS 37 *Provisions, Contingent Liabilities and Contingent Assets* requires the recognition of a provision, which is a liability of uncertain timing or amount. The amount recognized as a provision is the best estimate of the expenditure required to settle the present obligation at the end of the reporting period. lAS 37 also requires the recognition of liabilities related to onerous executor contracts.
>
> lAS 19 *Employee Benefits,* lAS 12 *Income Taxes* and IFRS 4 *Insurance Contracts* do not require liabilities to be measured at fair value but rather based upon the specific guidance in those standards.
>
> lAS 18 *Revenue* may in some circumstances require the deferral of revenue (i.e. recording of cash advanced by customers as a liability) which represents a perfonnance obligation.

In the context of a business combination, IFRS 3 *Business Combinations* requires that most liabilities be measured at fair value for purposes of determining the opening balance sheet of the acquired entity. We suggest that in developing its guidance, the Board alert valuers to the fact that (i) IFRS 13 applies to both financialliabilities [1] and non-financial liabilities[2] that are required to be measured at fair value, (ii) some non-financial liabilities are not measured at fair value, and (iii) some financial liabilities are only measured at fair value upon initial recognition.

---

1 lAS 32 defines a Financial Liability as "A contractual obligation (i) to deliver cash or another financial asset to another entity or (ii) to exchange financial assets or financial liabilities with another entity under conditions that are potentially unfavourable to the entity."

2 Non-financial liabilities are liabilities that do not meet the definition of a financial liability under lAS 32; Non-financial liabilities include performance obligations as well as non-contractual obligations that arise from litigation.

The IVSC guidance can supplement IFRS in the measurement of liabilities under the various scenarios discussed above, which will provide users with a consistent and robust set of principles which can be followed to enable transparent and consistent financial reporting.

Question 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.

The proposed definition of a liability in the DP is "an obligation which could result in an outflow of resources." The definition of a liability in the IASB's Conceptual Framework is "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." The definition in the DP is much broader than that under IFRS. This extension of scope should be highlighted and explained.

The proposed definition does not address when a liability should be recognized, and we support this stance. However, it may be helpful to point out to the valuer the distinction between the recognition of a liability (which for financial reporting purposes is governed by specific rules outside the scope of the valuers work) and the measurement of that liability (which a valuer may be mandated to value). For example, under lAS 37, a provision is only recognized if it meets specified criteria. Contingent liabilities are not recognised.

We suggest that the definition be expanded to include the words "from the obliger" (for example, "an obligation which would result in an outflow of resources from the obliger") which is similar to what IFRS uses to indicate that the scope only seeks to address the valuation of liabilities by the obliger (the party which has to perform under the liability) and not others who may have a vested interest in the liability.

Since most people associate the word "liability" with an accounting concept, maintaining consistency in the definition amongst the different frameworks is important and terminology which could cause confusion should be avoided – for example, the reference to the obligor. By convention, the obligor of a liability is usually referred to as "the issuer", instead of "the holder". We suggest the IVSC consider using the words "issuer" or "obliger" instead of "holder".

Question 3

Do you agree that liabilities arising under a financial instrument should be excluded from the scope of this project?

The IVS has already addressed the valuation of liabilities arising from financial instruments ("non-financial liabilities") in rVS 250, which primarily provides valuation guidance based on the definition of fair value in IFRS 13. We note that the specific guidance on liabilities in IVS 250 is largely limited to measuring own credit risk. We believe that there are other aspects ofthe valuation of financial instruments that could be addressed (such as valuation of derivative liabilities); however, we believe that should be addressed as part of a separate project. We support the current project focusing on the unique issues related to valuation of non-financial liabilities. Given that the measurement basis is fair value as defined under IFRS

13 for both financial instruments upon initial recognition and non-financial liabilities in some situations (e.g., business combination), it may be necessary for there to be conforming changes to IVS 250 after the project is completed.

Question 4

Do you agree that other liabilities such as rental payments, pension liabilities, insurance liabilities and deferred tax should also be excluded?

We agree that these liabilities should be excluded. Obligations to pay a defined sum such as rental payments and deferred tax liabilities generally are not the subject of a valuation report. Moreover, payments under some lease contracts may not be well-defined and some may vary depending on other variables like sales volume or be contingent on the occurrence of specified events. The value of deferred tax liabilities also may vary depending on the future change in tax rates. Therefore, the stated reasons for excluding them from the scope (i.e. obligations to pay a defined sum) may not always be valid.

Pension and insurance liabilities are typically the subject of an actuarial valuation, which we believe is appropriately excluded from the scope of this project.

Question 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.

We support including contingent liabilities within the scope of the project as these types of liabilities require significant judgment to measure and there may significant divergence in approach. We note, however, that whether or not there is a need to measure a contingent liability for financial reporting purposes depends on whether the recognition criteria have been met.

Question 6

Please indicate whether you believe potential litigation liabilities can or should be valued and whether they should be included in this project.

We agree with the view that many factors affect the outcome of litigation and the amount of outflow of resources required can vary significantly across different scenarios. Nevertheless, valuations of such liabilities are required both for financial reporting purposes and for management decision making. We thus propose including such litigation liabilities within the scope of this paper.

In some cases the valuation may serve to measure the entity's maximum exposure to loss based on an estimate of the plaintiffs total loss. A valuation expert would not likely be in a position to estimate the probability that a case would be resolved for a specific amount; however, the valuation of the maximum exposure might be an important input into management's determination ofthe most likely outcome.

If the scope of the paper includes the valuation of such liabilities, guidance should also be included on the selection and full disclosure of the inputs and assumptions used in the valuation so that users of the valuation are aware of its limitations. Needless to say, we strongly advocate consistency of all principles between IVS and IFRS to limit the potential for confusion amongst users of the valuations.

Question 7

For what purpose are you aware of liabilities being valued?

Valuation of liabilities are normally used for financial reporting requirements and as part of the decision making process by management – for example, should an entity seek to settle an obligation, or transfer it, or fulfill it. If the value of a liability is different under each scenario and possibilities exist for different courses of action, management decision making would usually take into account the different values of the liability.

Question 8

What basis or bases of value do you normally encounter?

A host of different valuation bases are encountered in practice. While the valuation at fair value using the principles under IFRS 13 is often used for financial reporting purposes, IFRS does not require all liabilities to be valued at fair value. This was discussed in detail in Question 1 above. Many non-financial liabilities are carried at amortized cost.

Question 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?

The various bases encountered for measurement of liabilities under IFRS would all draw to a greater or lesser extent from the different bases of value outlined in the IVS Framework. So while we agree that these bases may be appropriate for valuation of liabilities, it is important that any valuation for financial reporting purposes be in conformity with the applicable accounting standards.

The term "investment value" is defined as the "cost to a holder of fulfilling the liability". The term "investment" is usually associated with assets – we thus suggest using alternative terminology. The definition of this basis of valuation represents an entity-specific cost of fulfilling a liability (without an implied profit margin). Some entities may or may not use their resources efficiently in fulfilling their obligations, as a result of which their valuation of the obligation using this basis of valuation may be higher or lower than market value (or fair value) or from a "transfer value" which would be the value another entity would ascribe to fulfilling the obligation. For example, instead of performing under a liability, an entity may choose to transfer or outsource the obligation to a third party for fulfillment, and the third party may seek to include a profit margin to fulfill the obligation. We thus propose using the term "settlement value" or "fulfillment value" in place of "investment value".

The definition of "special value" is that it includes a premium above fair or market value, and this may exist in certain market transactions. It would be useful to include examples why an obligor would be willing to pay an amount in excess of the market value (and thus give rise to the premium) – for example, an obliger may for reputational reasons wish to fulfill (and thus value) an obligation at a higher than market or settlement value.

Paragraph 15 of the DP, in its definition of "fair value", includes a comment that fair value "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". A question arises as to why this special transferee is not considered to be a market participant and therefore drive down the "market value" to the level of this "fair value". We also question if this is not what is defined as "special value" in the DP. Also, it is not clear whether fair value is intended to refer to a transfer or settlement notion, as both terms are used in the definition.

Question 10

Do you agree that it may be necessary to modify some of the 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 are appropriate.

In addition to the issues described in the response to question 9, all of the references to assets should be removed since the DP seeks specifically to address the valuation of liabilities.

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.

Our only experience in market based approaches for valuation of liabilities would be in the context of non-financial liabilities.

Question 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.

Most non-financial liabilities within a business which is to be acquired or sold are often valued at fair value as defined in IFRS 13 for the purpose of financial reporting (acquisition accounting under IFRS 3 *Business Combinations)* and the fair value is computed using the DCF method. Similarly, a number of non-financial liabilities recorded at amortised cost for financial reporting use DCF valuation methods. In both these instances, because the inputs used in the DCF method maximize the use of observable market information, the resulting values are often close to market or fair value.

For management decision making purposes (whether to fulfill or outsource or transfer a liability), non-financial liabilities similar to warranty obligations, asset retirement obligations, liabilities to customers under loyalty programs, litigations and penalties are often valued at fair value (despite being measured at amortized cost for financial reporting purposes). The estimation of the fair value is usually performed using the DCF method as explained in the DP. The inputs used to estimate the fair values in the DCF method often maximize the use of principles consistent with the market approach as described in the DP.

Question 13

For the example given for question 12, please indicate the source of the projected financial information used in the cashflow forecast.

A variety of sources are used as inputs to cash flow forecasts including, but not limited to, past experience of cash flows incurred, internal estimates of future cash outflows, costs of resources utilized or to be utilized, statistics produced by third parties (inflation rates, indexes, etc.), information published by peers and competitors who need to value similar liabilities, and market based inputs (interest rates, commodity prices, etc.)

Question 14

For the example given for question 12, indicate what risk factors you reflected and whether these were reflected by probability weighting the cashflows or the discount rate.

For non-financial liabilities, the risk of increasing prices (inflation) and uncertainty over certain critical decisions (optionality in choices available) are typically reflected by probability weighting the cash flows, rather than utilizing a discount factor.

Question 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 for it.

We support the use of a risk free rate when estimating the current value of a future liability. Financial risks like the credit standing of the counterparty and foreign exchange risks are often valued and accounted for separately. Similarly, non-financial risks are reflected in the underlying projected cash flows.

Question 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.

We use simplified option pricing techniques for valuing liabilities which have a binary outcome – for example, when valuing the future outflow of resources under customer loyalty programs (the optionality being whether the customer will exercise their rights or not). More complex option pricing techniques are often used for liabilities relating to employee benefits (share based payments).

Question 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.

Paragraph 41(a) of IFRS 13 states that when applying a present value technique an entity might take into account the future cash flows 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. Therefore, at least in the context of measuring a liability at fair value for financial reporting purposes, a profit margin would be appropriately included.

Question 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.

The Cost Approach has traditionally been defined in the context of valuing an asset. However, if the Cost Approach is essentially referring in this context to the use of estimated cash flows to reflect the cost of fulfilling, transferring or settling/cancelling a liability, then in most cases the Cost Approach would be used to value a liability as such valuation would be determined based on the expected expenditures.

Question 19

Do you agree with the Board's proposed approach?

We do not agree with the statement in paragraph 38 that "not all liabilities which have to be recognized in financial statements prepared under IFRSs are required to be valued". All recognized liabilities must be valued; however, that measurement basis is not always fair value.

While we recognize the needs of the Board to produce standards that apply to a wider context, the underlying objective of the DP should not be to provide guidance to value a liability for "other than financial reporting purposes" (quoted in the Background section and in paragraph 40). All the examples presented in paragraph 6 require the measurement of the liability by estimating the "monetary value or the cash equivalent amount of resources required to extinguish a liability or fulfill the obligation". The users of the valuation the Board has identified in the introduction to the Discussion Paper (valuation providers, liability holders, investor groups, professional bodies and regulators) all currently require consistency between the recognition and measurement of liabilities with financial reporting principles. While valuations of liabilities will be used in other contexts (i.e., litigation and other legal proceedings, management decision making, etc.), many valuations are, in fact, performed for financial reporting. For liabilities which fall within the scope of both IFRS and this IVS, if a value is generated using an approach that is inconsistent with IFRS, it is likely to create confusion over what the value represents and how should any difference in the value (from IFRS) be treated. It is important that the Board clearly identifies when a valuation approach is inconsistent with financial reporting standards.