April 30, 2013

Sent via email to commentletters@ivsc.org

IVSC Standards Board
International Valuation Standards Council
41 Moorgate
London EC2R 6PP
United Kingdom

Dear Sirs:

THE CANADIAN INSTITUTE of
CHARTERED
BUSINESS
VALUATORS™

**Re: Comments on IVSC Discussion Paper – Valuation of Liabilities**

The Canadian Institute of Chartered Business Valuators (CICBV) is pleased to provide our comments on the above noted IVSV Discussion Paper concerning the valuation of liabilities.

**Responses to Questions posed in the Discussion Paper**

**Question 1**
**Do you agree with that the IVSC should produce a standard or guidance on the valuation of liabilities as defined above?**

> **CICBV Response**
> We agree that the IVSC should produce a standard or guidance on the valuation of liabilities. However, given this main goal/objective, we are not sure why the Discussion Paper is not structured or worded in such a manner that it is applicable to all liabilities in general. Perhaps there can be general guidance or a discussion paper on a definition for all liabilities and then more specific guidance or discussion papers on specific types of liabilities.

**Question 2**
**Do you agree that the possible definition of a liability given above is both clear and adequate?**

CICBV Response

The definition included in the Discussion Paper is relatively simplistic – a definition closer to the IFRS definition would be more appropriate.

Question 3

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

CICBV Response

While complex financial instruments can present unique issues which warrants exclusion from the discussion paper, it would none the less be very useful if the Discussion Paper could be more general so that one standard could address all types of liabilities, including financial instruments.

We would suggest that the definition of financial instruments be refined to ensure that the guidance clearly indicates what is included or excluded from its scope. For instance, certain liabilities such as contingent consideration with embedded derivatives can have characteristics similar to or consistent with financial instruments.

Question 4

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

CICBV Response

We agree that these other liabilities (rental payments, pension liabilities, insurance liabilities, and deferred income taxes) should be excluded and they should have their own IVSC guidance. However, the general IVS definition of liabilities should also apply to these liabilities.

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.**

CICBV Response

Contingent liabilities described in the Discussion Paper should be included in the guidance, including contingent consideration, unless such contingent liabilities have embedded derivatives or can otherwise be classified as financial instruments.

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Question 6
**Please indicate whether you believe potential litigation liabilities can or should be valued and whether they should be included in this project.**

CICBV Response
Yes, we believe that potential litigation liabilities can be and should be valued where the appropriate thresholds are met in terms of likelihood and measurability; however the valuation of litigation-related liabilities involves numerous factors. While disclosure by the holders related to their views on these factors or a disclosure of the estimated value may not be practical or appropriate given the nature of these liabilities (e.g., the counter-party could use such information against the holder in court while litigating the related liability). As such, disclosure may be the most appropriate course of action until such liabilities are reasonably estimable or the amount is known with a sufficiently high degree of certainty.

Question 7
**For what purposes are you aware of liabilities being valued?**

CICBV Response
Purposes for which liabilities are valued include taxation, financial reporting, mergers and acquisitions, and restructurings.

Question 8
**What basis or bases of value do you normally encounter?**

CICBV Response
The basis of value generally encountered includes fair value (financial reporting, restructuring) or fair market value (tax, mergers or acquisitions).

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?**

CICBV Response
We agree.

**Question 10**
**Do you agree that it may be necessary to 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.**

CICBV Response
It may be useful for the definitions to more closely mirror the IFRS definitions. We would think however that the bases of value would be that same for assets, liabilities or equity.

**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.**

CICBV Response
The market approach is not generally used in directly valuing liabilities. However, the market approach can be used to help with inputs that go into an income-based approach in valuing certain liabilities (e.g., in valuing deferred revenues, market-based inputs such as market operating margins, operating costs, commodity linked notes, discount rates, etc. are often used).

**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.**

CICBV Response
Examples of where the DCF method is used include:

(i) deferred income taxes in a tax-based valuation for the tax purposes where the FMV of goodwill needed to be determined so book value was not an appropriate measure for deferred income taxes;
(ii) deferred revenue in a purchase price allocation under US GAAP or IFRS (financial reporting);
(iii) contingent consideration in a purchase price allocation under US GAAP or IFRS (financial reporting); and
(iv) debt or bonds for pricing an acquisition, tax, and financial reporting purposes.

Question 13

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

CICBV Response

The source of projected information would board-approved projections, acquisition / deal models, underlying debt agreements or contracts, and purchase & sale agreements.

Question 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.**

CICBV Response

The risk factors reflected in the liability valuation relate to the likelihood of payment or expected outcomes. We are aware of the use of various adjustment approaches which include adjusted cash flows, adjustment of the discount rate and hybrid combination of the two.

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 to support it.**

CICBV Response

The discount rate used will depend on whether or not the anticipated cash flows have been risk adjusted or the degree of risk adjustment. If the cash flows are truly risk adjusted then the discount rate would normally be the risk free rate. If the discount rate is to be risk adjusted then the risk-free rate is just the starting point for the discount rate used in the valuation of a future liability and would represent the absolute lowest risk that could be used. The relative ranking of the liability as compared to the other liabilities of the entity, including the relative rates of return for the various other liabilities (e.g., accounts payable would be the lowest risk and the rate of return would be close to the rate of return on working capital and preferred shares could be the riskiest type of debt-like liability with a rate of return close to the lowest possible rate of return on the entity's equity, with all else being equal). The term of the liability would also be a factor in determining the relative amount of risk and appropriate rate of return in comparing it to other liabilities of the entity.

**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.**

CICBV Response
We are aware that option pricing models are often used to value contingent consideration or in deriving the split between common and preferred shares, bifurcation of debt and equity etc. These valuations are often prepared for financial reporting or tax purposes.

**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.**

CICBV Response
A profit margin should not be included to reflect the risks to the holder of the cost estimate proving inadequate, but rather, a profit margin should be included to reflect the incentive the transferee would require to assume the liability, over-and-above the costs to fulfill.

**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.**

CICBV Response
We are aware that the cost of fulfilling, transferring, or cancelling an equivalent liability can be determined based on:

(i) the operating costs required to fulfill the liability, excluding sales and marketing costs which have already been incurred before or as the liability was initially created. These costs can be implied by the projected profitability of the economic benefits or asset related to the generation or settlement of the related liability.

(ii) operating costs of comparable companies providing the same product, service, or function required to fulfill the liability being valued.

Question 19
Do you agree with the Board's proposed approach?

CICBV Response
We agree with the Board's approach, at least from a financial reporting perspective.

General Comments on the Discussion Paper

1. We assume that the IVS will be updated to reflect a new definition of liabilities, consistent with this Discussion Paper and IFRS definition.

2. Before finalizing this guidance, it might be prudent to wait for the IFRS guidance on liabilities, although this may not be practical since the project has been delayed.

3. The term "financial instruments" is used through the document, but some of the items specifically included in the scope of the Discussion Paper can also be considered as financial instruments. A solution might be to include all liabilities under the scope of this Discussion Paper by making it more generic and applicable to all liabilities, given that the main objective is to ensure that liabilities are defined under IVS.

4. Throughout the Discussion Paper, there are references to "monetary" or "pay" in reference to valuing or settling liabilities. It is recommended that all such references be replaced in consideration of the IFRS definition of liabilities which defines settlement as "an outflow from the entity of resources embodying economic benefits".

5. Throughout the Discussion Paper, there are references to "beneficiary" – a beneficiary can be different than a counter-party. As such, it is recommended that all references to "beneficiary" be replaced with "counter-party".

Specific Comments on the Discussion Paper

1. Paragraph 2 – instead of "The obligation may be a single event or a series of events", consider revising to "The obligation arising from a single past event or series of past events", as this would be clearer in terms of what the liability is and when it arose, as well as being more consistent with the IFRS definition of a liability.

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2. Paragraph 5 – recommend that the term "payment" be replaced in consideration of the IFRS definition of liabilities. Perhaps "a payment" can be replaced with "resources embodying economic benefits".

3. Paragraph 6 – another point to include would be "to fulfill regulatory requirements", which unlike the first bullet, may not always result in restoration or reinstating an asset (e.g., a liability associated with decommissioning a nuclear plant). In addition, this paragraph goes on to state that "the common factor is that all involve the consumption of economic resources by the holder of the liability" – a better statement could be that "the common is that all involve an outflow of resources by the holder of the liability".

4. Paragraph 11 – the first bullet point describes certain liabilities that are contingent but not considered to be financial instruments. However, a contract for the buyer to pay an additional sum to the seller can be a very complicated calculation could have characteristics that many would argue is in fact a financial instrument. In addition, it is our view that contingent liabilities also be included in the scope of this project, perhaps by having a general or expended definition of liabilities that states that the value of liabilities can also be based on the present value of the probability adjusted future economic outflows related to the liability".

5. Footnote 2 (page 4) – recommend that a clear definition of a financial instrument liability also be provided so that it does not conflict with the liabilities being included within the scope of the Discussion Paper.

6. Paragraph 15 – this paragraph indicates that there are three categories, but it actually lists four categories.

7. Paragraph 16 – states "market participant may be the same" – this would be a big coincidence if the values would be exactly the same. Might be more appropriate to say "market participant may be approximately the same".

8. Paragraph 18 – the phrase "…holding a liability which may useful…" is missing the word "be: and should read "holding a liability which may be useful…".

9. Paragraph 23 – suggest that the phrase "….transaction data have no relevance." Be replace with "….transaction data have relatively little or no relevance."

10. Paragraph 29 – this paragraph states that "…risks associated with a liability are often better reflected in the cash flows than in the discount rate". This statement is somewhat confusing given that a key concept is that both the discount rate and the cash flows must match, rather than where the risks are actually reflected.

We hope that this submission is helpful to you. If you have any questions regarding our comments, please do not hesitate to contact Robert H. Boulton, CA, CBV, CICBV Director, Education and Standards.

Yours truly,

Robert H Boulton, CPA, CA, CBV
Director, Education and Standards