American Appraisal Associates, Inc.
44 Montgomery Street, Suite 1050, San Francisco, CA 94104
tel 415 764 1677 / fax 415 764 4825

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American Appraisal

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International Valuation Standards Council
68 Lombard Street
London EC3V 9LJ
United Kingdom

Re: Discussion Paper
Valuation of Liabilities

Dear Sirs:

Attached for your consideration are our responses to the Questions for Respondents in the Discussion Paper entitled “Valuation of Liabilities”.

As stated in the Background to this Discussion Paper, the International Accounting Standards Board has established that there is a lack of guidance specifically related to the valuation of liabilities, and that a need for such guidance exists. The IVSC Standards Board has agreed that a dedicated project is required to determine appropriate valuation practice for liabilities. As a firm of valuation professionals, American Appraisal Associates supports these efforts thoroughly.

Sincerely,

Gerald J. Mehm

Gerald J. Mehm
Senior Vice President & Senior Managing Director

American Appraisal

IVSC Discussion Paper

Valuation of Liabilities

Question 1: Yes, the IVSC should produce guidance on the valuation of liabilities. But in paragraph 2, it should be expanded to state that not all liabilities have a "beneficiary," or an entity to which the obligation is owed. For example, there may be a statutory requirement to decontaminate a site. There is no payee in this case.

Question 2: The definition should be modified as follows: "An obligation which **is expected to** result in an outflow of resources." The term "could" seems misleading.

Questions 3 and 4: Paragraph 9 states that financial instruments, pension liabilities, and insurance liabilities are the subject of existing or proposed standards and guidance. We submit that this reasoning also applies to lease obligations and deferred tax liabilities, as they are also the subject of existing or proposed standards and guidance **for financial reporting purposes.** Perhaps it should be stated that any guidance proposed by the IVSC for the valuation of liabilities will be subordinate to guidance issued by the IASB or FASB for these classes of liabilities.

Question 5: Contingent liabilities such as those described in paragraph 11 should be included in the guidance. The guidance should also cover such contingent liabilities as proposed site remediation obligations, and litigation liabilities.

Question 6: It is admittedly difficult to estimate the potential litigation liability for any one lawsuit. And litigating attorneys will resist any attempt to disclose such potential obligations, as they are of the opinion that such disclosures impair their ability to represent their client. However, companies are typically the subject of a number of lawsuits at any one time. Considering the total potential damages, and assigning a probability to the total amount, can provide an estimate of the total liability without assigning an obligation to any one suit.

Question 7: Liabilities are typically valued for financial reporting purposes.

Question 8: The basis of value is "Fair Value" as defined by the IASB and the FASB. This is equivalent to "Market Value" as defined in the IVS Framework.

Question 9: The only basis of value that is appropriate for liabilities is "Market Value" as described in the IVS Framework.

Question 10: One of the important considerations in the valuation of any asset is "highest and best use." This concept does not apply to liabilities, as no holder of an obligation looks to maximize their potential payout. The terms "Investment Value" and "Special Value" have no relevance when valuing liabilities. The valuation of liabilities should be based simply on the lowest amount at which the holder could satisfy, settle, or transfer the obligation.

Question 11: There are two instances where a Market Approach can be used to value liabilities:

The first is where the entity has publicly-traded debt. Here, investors who hold the debt as an asset will determine its value based on the stated interest rate compared to the required rate of return. If the interest rate is greater than the required return, the debt will trade above the principal amount. Conversely, if the interest rate is below the required return, the debt will trade below its face amount. The value of the debt as an asset is used to value the liability to the holder.

The second instance is where the entity has bank debt that is not publicly traded, but is comparable to publicly-traded debt of entities in the same industry or with similar risk characteristics. The yield-to-maturity of the comparable public debt can be used to adjust the stated interest of the subject debt to a market rate and value the principal of the debt.

Question 12: When valuing contingent consideration for financial reporting purposes under FASB ASC 805 or IFRS 3, Business Combinations, a DCF model of the expected payouts is used.

Question 13: The source of the projected financial information used in the DCF model is management of the acquiring company.

Question 14: In all cases, the starting point is the WACC. This is typically the WACC of the acquiring company, but it may be the WACC of the target if the target has a greater risk profile than the acquirer (newer technology, greater competition, riskier industry). The WACC may also be adjusted for projection risk, such a higher growth rate or higher operating margins than historically.

For contingent consideration tied to meeting certain levels of revenue or operating income, the payout triggered by the projected financial information is calculated, and discounted to present value at the adjusted WACC. For contingent consideration tied to achieving a particular outcome (receipt of FDA approval for a drug, or awarding of a major contract for a defense contractor), achieving the benchmark is assigned a probability, based on discussions with management. The probability of the payout times the payout is then discounted to present value at the WACC.

Question 15: We do not consider a "risk free" rate to be appropriate when estimating the current value of a future liability. Even in cases when the future payout is certain, such a deferred consideration payment, the appropriate discount rate would be at least the entity's cost of debt.

Question 16: We have used option pricing to estimate the current value of contingent consideration when the payout amount is tied to the future value of the shares of the acquirer.

Question 17: As discussed in paragraph 33, when estimating the cost to remediate or decontaminate a manufacturing site, that cost would properly include a profit to the contractor who performs the cleanup. For liabilities which the entity will satisfy or settle with internal resources, the estimated cost should not include a "profit margin" to reflect the risks of the cost estimate proving inadequate. The liability, rather, would be adjusted in the future as the event triggering the liability comes closer, and the estimate can be updated. And the discount rate should not include such a risk premium, as this addition would reduce the present value of the obligation.

Question 18: As we stated in our response to Question 10, it is incumbent upon an entity to minimize the cost of fulfilling an obligation, as it is incumbent to maximize the value of and asset by considering it highest and best use. Therefore, in estimating the value of a liability, an entity should consider all the possible ways to fulfill, transfer, settle, or cancel an obligation, and determine the most cost-effective approach. An estimate of the most cost-effective approach is then determined currently. This cost should then be inflated to the date of the settlement, and then discounted to present value at the cost of debt to the entity.

Question 19: We agree that the most common purpose for which liabilities are required to be valued is for financial reporting purposes. And we agree that future guidance on the valuation of liabilities should summarize the requirements under IFRS and US GAAP, and relate them to the guidance proposed by the IVSC.