

International Valuation Standard Council  
Valuation of Liabilities Project  
Comments on the Discussion Paper  
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**Object : IVSC Discussion Paper – Valuation of Liabilities**

Dear Sirs

The International Valuation Standard Council (IVSC) issued a Discussion Paper on February 5<sup>th</sup>, 2013 to examine the valuation of liabilities for which it is seeking comments from the business community. I understand that The Canadian Institute of Chartered Business Valuators will issue comments on this Discussion Paper. The purpose of this letter is to provide my comments on this document to both organizations and hopefully provide valuable input on specific issues with regard to the insurance and pension business in particular.

I am Vice-president, Acquisition and Corporate Development at Industrial Alliance Insurance and Financial Services Inc., a public insurance company in Canada. In the performance of that function I am involved in the valuation of the business or assets we buy or sell and their integration in our organization. My background is investment and portfolio management, and I was one of the implementers of the asset and liability matching in 1986 at our company. I am neither an accountant, an actuary nor a lawyer, but I have the opportunity to work with these professionals on a daily basis. I try to apply the logic of an economist in analysing the many facets of the different types of business in which our organisation is active, including Insurance business for protection, wealth management for accumulation, distribution of financial product, portfolio management and pension funds management. I am representing here my personal views on the subject not the view of Industrial Alliance Insurance and Financial Services Inc.

My objective in this communication is to argue that there is a need for standards or guidance on the valuation of liabilities in a wider context. However, one size does not fit all and the valuation of any asset or liability, or the net of both, should be function of the objective of the current user, not in relation to a hypothetical user in a hypothetical market using a hypothesized discount rate. My understanding is that valuers don't want to deal with fiction and while nothing should be excluded, each type of asset or liability have their specificities that need to be recognized.

Different professions may claim to be the appropriate valuator for a specific type of asset or liability. The expertise I would consider as the main characteristic of a professional valuator is to perform their analysis on the basis of a *sale process*. An actuary may be trained to perform reserve calculations but the task of

transferring the liability to another party raises a more global picture, the *reality check*. If you want to understand what you own or owe, try to sell it or transfer it to an arm's length party: Then you will know.

### **General Comments**

I was pleased to learn of the Valuation of liabilities Discussion Paper produced by the International Valuation Standard Council and I was surprised that this organization had not intervened earlier on the subject of liability valuation. I am not fully knowledgeable about the history of your organisation and my expectation may seem to you out of reach. However I understand that one of the motivation behind the Valuation of Liability project is for IVSC to represent the valuation process in its entirety and to have it understood and recognized by regulators and other professions. I encourage you to do so.

While it is generally assumed that everything can be valued, the task of doing so is not an easy one. There has to be a conscientious effort to understand the nature of the different business models to achieve the vision of building a valuation profession globally.

When I think about the valuation in its entirety, I include regulated financial institutions and financial products, an area which is highly visible but unfortunately not very well understood outside the financial industry. By nature, the financial institution derives its existence from its liabilities, also the ultimate focus of the regulators, even though it is more often considers from the outside for its assets rather its liabilities. The accounting world and the valuation world are not well prepared to deal with financial institution type of activity and typically apply concepts which are more common to physical assets; in my view the financial reporting has yet to recognize the specifics of financial institutions and regulatory requirements.

I am very sensitive to what is an active market and very concerned by the lack of substance in the way the concept has evolved recently. Not all markets are alike and most of them, especially the financial market, are very recent. As an example, an important subset of the financial market in Canada, the *money market* is the result of initiatives by the Bank of Canada in cooperation with some financial market participants starting in 1953 through the late 1960's. The history of Government of Canada marketable bonds in the domestic market dates back to 1868 while the Bank of Canada only opened in 1935. Setting a market structure in place is a major task that stands in huge contrast to the current vision which I would summarize by the simplistic request: "Markets! Give me a discount rate".

There is also a big contrast between the analysis of the economic process of fixing prices in a market process and the accounting world perception of a structured market. To move away from the historical background of your organisations you have to go beyond the view that "Real Estate is one of the largest classes of assets on the balance sheet of a business and provides a strong base upon which to build a valuation profession"; you can't value equally other assets classes such as plant and machinery, business, derivatives, fine arts, jewellery, you have to find their own specificities. The idea of a fixed standard that applies to everything is a false security. I like to think that the solution to a project is the sum of the constraints, if you don't identify an important constraint your solution will fail. If you don't recognize the specific nature of a certain liability, your valuation is false.

To make clear to you my objectives in performing the current analysis I must outline some of my frustrations with some of the current financial world issues. I am always interested in understanding the objectives and the challenges. The background section of the Discussion Paper makes some statements

on different elements of great interest to me, but fails to indicate their relevance to the current project. While we must understand that these elements are sources of motivation to become involved in the Valuation of Liabilities project, it is not expressed as such. The background section makes reference to the Exposure Draft issued in 2010 by the IASB and states that the responses received to the draft illustrated a significant diversity of opinion, not only on when a liability should be recognised in a financial instrument, but also how it should be measured. There is a lack of reference on the nature of the debate. I would say your final objectives are not obvious and the rationale for the Board's view expressed in the Discussion Paper needs some additional explanation. Somehow I find your motivation not very strong.

As an example, it is stated in the section Project Scope that the IVSC project on the valuation of liabilities excludes liabilities created by a financial instrument because they have distinct characteristics and would in any event be covered in the proposed project on financial instruments valuation. I felt that it lack coherence with the earlier comment to the point that "there is a need for standards or guidance on the valuation of liabilities in a wider context".

When it is stated that excluded from the scope of this project are liabilities arising under a contract to pay a specific sum of money on a future date, whether contingent or fixed, all financial instruments, pensions, rental payments under leases or contingent consideration arrangements in other contracts, I have the feeling that the IVSC believes it can isolate itself from the unresolved questions around these issues. I would suggest the opposite hence the IVSC should get involved.

If the Introduction to the International Valuation Standard (IVSs) states that the standards apply to the valuation of both assets and liabilities while "*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*", it is illustrative of the simplistic view that the rules and valuation technique have and the need for some deep thinking.

I hope to be able to contribute to this thinking in answering your questions.

Sincerely

A handwritten signature in black ink, appearing to read 'Y. Sauvageau', written in a cursive style.

Yvon Sauvageau

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## Question 1

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

While the objective of the International Valuation Standards (IVSs) is to apply valuation techniques to both assets and liabilities, it appears to me that the IVSC has underestimated, up to now, the challenge of valuing the liabilities, and wrongly assumed that a liability is simply the negative image of an asset. You will meet a client that says “I want to sell my assets at good price”, but rarely a client that says “I want to sell my liabilities at good price”. This simplistic view in regards of assets and liabilities has to be reviewed and the IVSs improved. A significant diversity of opinion exists but many are over simplifications without analysis. The objective at this point in time should be to bring some well thought input to the discussion from the perspective of an analyst in a context of a sale process. If the objective of the valuation is set properly, many questions will find their own answers easily.

In light of the recent past, the objective of producing a standard at this point in time may be too ambitious, but the IVSC can't be absent from the analysis. As an example, it is hard to understand why IVSC did not comment in regard with the IFRS Insurance Contracts project. On what basis did the IVSC come to the conclusion of a distinction between the insurance liabilities from other type of liabilities such that it would not meet its own term of reference?

The reference to a “guidance on the valuation of liabilities” would be more accurate than the notion of “standard”; while everybody talks standard, we must know that *one size does not fit all*. We need to understand that the *means* is a statistic without existence which may be the characteristic of no single observable entity within a group; but more important, we can't assume that the entity can be split into separable individual characteristics having their own existence. We need to deal with the real world with all its complexity. We can never say it often enough, judgement is an essential input to perform valuation analysis.

## Question 2

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

I believe the definition such as “*An obligation which could result in an outflow of resources*” makes economic sense to me and we can use that concept. I would try to use something more specific than “obligation”, but the proposed formula does reflect the fact that the process of establishing a liability requires making a link between an obligation and the utilisation of resources to fulfill that obligation. This is why asset and liability management are so natural for a financial institution.

There is no market for liabilities, not even the “Carbon Market” which is a popular topic. The fulfillment concept is what constitutes for me the best way to consider liabilities. I don't believe that the liability can be measured on its own. The basic concept when we negotiate an assumption reinsurance agreement is to put the counterparty “in the shoes” of the initial insurer with regard to the liability; the notion of transfer can only apply to the asset portion of the transaction which measures the compensation for taking on the obligation. In fact, even in the case of a defaulted insurance company, the “liquidation” of the company does not result in the extinction of the insurance liabilities. By law you can't sale an insurance contract to another party.

### Question 3

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

The idea of producing a standard on the valuation of liabilities which would exclude financial liabilities that arise under the term of a financial instrument while using the definition of liability as “*An obligation which could result in an outflow of resources*” is a contradiction! If we agree with the proposed definition, I can’t see how such definition would allow the exclusion of financial liabilities simply because the cost of the obligation is not defined. There is no justification to state that they are excluded unless you do so by convenience. You should not be intimidated by the notion of financial instruments or financial derivatives, so don’t exclude them from the scope of this project on their names; you need to know what they are; a business rarely deals with a single event and a structured market won’t be set to deal with a single transaction. I don’t agree excluding from the valuation practice for liabilities those arising from financial instruments. I can’t see how we can accept an argument to put on an investor’s list of liabilities the “value” of an option exercisable by the issuer to repay a preferred share after a certain date. This is a good example of fiction.

### Question 4

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

There could be some temptation to exclude insurance liabilities because the actuary would pretend that this is their expertise; it is partly true for some actuarial aspects of the product but actuaries don’t have and should not have the monopoly of the global valuation of insurance liabilities. While I am working with actuaries to value the assumption reinsurance agreement transaction I am involved with, it is a specialty area and not typical for all actuaries. You don’t need to be a CA to analyse financial statements or an engineer to value a building and it is not because you are an accountant that you can perform valuation.

While it is never said in the documentation, the Discussion paper is possibly inclined to exclude from its scope certain types of liabilities on the basis of special expertise such as real estate, actuarial science and laws. I would argue that performing a valuation requires the input of different type of expertises and because of its global perspective it would not be useful to make such exclusion. The generality of the principle will be better established if such exclusions are not allowed.

### Question 5

**Do you consider that contingent liabilities as described above should be included?**

I see no reason why the contingent liabilities as described in section 11 of the Discussion paper should be excluded. In fact I would argue that most liabilities are contingent in some aspect. You simply have to read a trust indenture which describes a specific debenture to understand the contingency; market participants who ignore it will pay for their mistake.

There are only two certainties in life, *death* and *taxes*. Taxes are perceived (and it is) as so complex that people are tempted to move away from them. While accountants and lawyers don’t make statements without consulting their tax expert, these experts issue opinions; you need to take that opinion within a

context of valuation. Someone should be there to ask questions. I have seen situations where the tax person issues an opinion that a liability should be accounted for simply because he did not want to argue with their tax reviewer and compromise by setting a provision rather than a tax liability. If taxation is not specific to accountants why is a valuator not involved while an accountant would be. We should make a distinction between a tax opinion and the valuation of a deferred tax liability.

The life insurance industry is constructed on the contingency generated by the uncertainty surrounding death and sickness. Considered as a single event on a single person it would be impossible to construct a business, but sharing the interest among a larger group, the transactions become a business of protection. While there is no certainty for a single life, the contingent liability of a larger group of individuals can be assessed. The valuation process should be the performance of some prediction of random single events. Therefore there is no reason to exclude contingent liabilities from a business point of view; they should be included.

### **Question 6**

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

In matters of litigation, unless you know the argumentation the judge or the arbitrator will eventually based his or her decision on, there is no ground to proceed with any valuation, not even with the wording of the law or regulation. You can value the claims on some specific argumentation but most likely this argumentation will not be the one the judge will conclude on. When you are in the court room you are before a man or a woman not in front of the Law. The idea that we can put a probability calculation on the outcome is completely wrong. How can you argue on a valuation that you know for sure will not be the final outcome of the litigation. If you ask your lawyer if you have a good case, he will most likely say yes; when you ask him to set some probabilities he will argue it depends on which judge will be assigned to the case, but the judge assignment is usually not known until the auditing of the case. Therefore it is impossible and improper to value something which is unknown. If you are hesitant to classify as an asset your claims against a third party why would you, without hesitation, put as a liability the claims against you by such third party?

I agree with the idea that the reserve or provision to cover the possibility of having to pay the damages and costs 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.

Therefore the valuation of a litigation liability should be expressed from a cost approach, how much you will need to spend to defend or win the case. By performing such a valuation the participant will better assess the opportunity cost of using the system of justice which may be wrongly perceived as being a free service.

### **Question 7**

**For what purpose are you aware of liabilities being valued?**

I have been involved in several Assumption and Reinsurance Agreements, the typical transaction by which insurance liabilities are transferred from one insurer to the other and the valuation of the corresponding

asset transfer required. I am also involved in different employee pension funds as trustee or investment expert with a main focus on the liability valuation; for these organisations the valuation of the surplus or deficit is very critical. I was one of the implementers of the asset and liability matching in 1986 at our company and I am also interested in the current discussion concerning IFRS 4 II – Insurance contracts, more specifically the choice of a discount rate to value the liability in the financial statements.

## Question 8

### What basis or bases of value do you normally encounter?

Over the last 40 years I have been involved in several hundreds of transaction of which about fifty of them were executed; each one was different from the other. I can testify also that some of the ones we did not complete are the best decisions we ever made and the driving force for the decision of not executing the proposed transaction was on the valuation of the liabilities, very rarely the valuation of the assets.

Ultimately the base of value is in the eyes of the buyer; I have not yet seen a negotiated transaction without a minimum level of *compulsion*, a transaction will occur or will not occur. As my lawyer friends say “the lady can’t be half pregnant”. There is only one market price; the value at which the transaction was executed with each of its characteristics. This value is a composite price very rarely explained in each of its elements. Anything else is an estimation and should not be given a real existence by simply adding qualification to the concept. The price at which a market participant would agree to fulfill the liability of another party includes the nature of such liability and a strategy to manage the fulfillment of the guaranty and all the other considerations attached to it including its profit margins and its capital requirement as a regulated company if this is the case.

There is a false opinion that the structured market is the most frequent way to establish the price. In fact the only structured market in Canada that operates under the market principle is the stock market; bonds are traded by an investment broker as a capital instrument not as market maker. The Market Price as defined in the text book is rarely available. We should be very prudent not to refer to anything else than an estimated value, the current notion of “Fair Value” gives too much room to a hypothetical situation.

There is no such thing as a unique fair value since the *estimated price for the transfer of assets or liabilities between identified knowledgeable and willing parties that reflect the respective interest of those parties* can be anything including fiction.

Your suggested wording for the definition of Investment Value which would represent the cost to a holder of fulfilling the liability is wrong. For a financial institution the liabilities come first, the investment comes after. Using your wording would qualify the *premium* paid by the client as an investment of the insurance company while it is the price to get the protection.

The way the Special Value is defined makes it fiction; the market price is a composite and while many elements will be considered in its ultimate quantification each of these elements are not validated in the transaction process, they are estimations for the sole benefit of the buyer or the seller. As a matter of fact, the estimations of such special value made by each party and recorded in each one books as part of an executed transaction between these parties are most of the time different values. To be more exact I never saw identical assessments being used by both parties as part of the disclosure requirement post transaction.

It should be noted that these definitions present similar weakness as applied to asset valuation. The price of a bond includes some element of cost of funds, time value of money, reinvestment, credit, liquidity, taxation, foreign exchange on top of computation and settlement standards; none of these components are explicitly identified in the transaction process. The results of the top down or the bottom up approach to value these components can't be attributed to the market participants, they are valuations rationalized by third parties most of the time not involved in the transaction. There is a single composite market price, any attribution of value can't be labelled as an explicit market element and while everybody does it, the discounted value of different subsets of cash flows are not a valid additive mathematical concept either.

While there could be different ways to value an asset or a liability I have a hard time to accept that the valuation rules, the accounting rules and the tax rules can be so far apart. Too often I hear the following comment: It makes no sense but it is the way it is. The truth is that these rules evolve within a given background and when you understand it you can perform sound analysis.

#### **Question 9**

**Do you agree that the bases that are appropriate objectives for a valuation of liabilities fall within one of these categories described in the IVS Framework?**

No, not as written. If we ignore the distinction between a specific party and a market participant I would agree with the following "fair value represents the price that a holder of a liability would have to pay to transfer the liability to another party". I am not at ease with the concept of "settling a liability" with another party, we can only settle with the contracting party. It is impossible and arbitrary to qualify some reason as "special" compared with the other reasons that motivate a buyer or a seller. If you start to make such a distinction you will end up with a market participant that has no reason to make a transaction; every transaction has a purpose and each of them could be qualified as "special". The utilisation of the concept of market participant is an element of fiction; it is easy to identify precisely something that does not exist.

#### **Question 10**

**Do you agree that it may be necessary to modify some valuation definitions in the Appendix in order for them to be applied to liabilities as opposes to assets?**

You should move away from the temptation to replicate the bases of value definitions used for assets to deal with liabilities; start from a different perspective. The value of a bond held as an investment is different than the value of the liability to the company that issued that bond. The value of the cash balance at the bank for the owner of the bank account is different than the deposit liability as measured by the financial institution. The value of an insurance contract for an individual is different than the liability for the insurer. The market value of a single insurance contract as a standalone instrument makes no sense unless included within a diversified portfolio of contracts.

The true economics of the liability is that its value depends upon the fair value of the assets required to fulfill the obligation and its specificities. The idea that the value of the liability should be independent of the assets and independent of the business model of the issuer is wrong. Unless we make such a link between the assets and the liabilities it is unclear what discount rate should be used. If you argue that the liability evaluation ought to be totally independent of or at least not directly related to the composition of

the assets held, it is like saying that there is only one acceptable way to fulfill the liabilities. By comparison it is a situation where the valuator would be perceived as more knowledgeable than the company who operates its business and even more, there is only one way to operate the business. Liability valuation is a matter of business valuation not simply a valuation of an independent stand alone liability.

As for the argument that we need a *single method* that would work for all liabilities across all industries this is an overly simplistic view; if this were true you don't need a valuator. No wonder the IASB's liabilities project is currently paused. Such an objective is not realistic and has no justification; it is a dream that can't have any existence. It is argued by some regulators that the plurality of method used by actuaries reduces rather than increases the credibility of the actuaries' approach, while we teach analysts to validate their conclusion using different approaches. The basis is that the value of an instrument is different depending on the different parties that look at it. There can't be certainty in a world of uncertainty. A probability weighed scenario using multiple variables will not bring certainty even with a 99.9% probability threshold.

When you value liabilities not only you have to take into account the element of risk related to the liability cash flow but you have to take into account how safe are the cash flows coming to you on the asset side. When rating agencies assess the claim paying ability of an insurance company, they can't ignore the nature of the liability being taken on neither the investment portfolio held by the insurer. What would be the purpose of valuing a liability with an arbitrary discount rate disconnected from the nature of the liability?

I agree that it may be necessary to produce alternative definitions to enable the concepts to be more readily applied to the valuation of liabilities.

#### **Question 11**

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

When I first put in place the asset liability matching at our company I instinctively used the internal rate of return of the matched portfolio to value the liability. It is true that at that time the fixed income assets were accounted at amortized value and we had to apply the principle of the maintenance interest reserved when assets were substituted for other assets. I am still convinced that this is the best method to use. While there is some attractiveness in valuing everything at market value, we can see in the current discussion about Insurance liabilities that such a sound principle using the liability valuation is impossible.

I am also involved in different employee pension funds as trustee or investment expert; for these organisations the valuation of the surplus or deficit is very critical. As a matter of current topics being discussed on the subject, a group of pension experts issued on April 17, 2013 a report about *Innovating for a Sustainable Retirement System*. One of the recommendations in that report is to change the current valuation for pension funds and use different rules for different subgroups of participants in the plan.

I agree that many approaches are applicable to valuation of liabilities and market approach has little application to the valuation of 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?**

In the case of the Assumption and Reinsurance Agreement I was involved with, the fair value measurement technique used was a discounted risk-adjusted cash flow technique under an income approach. The general elements of the discounted cash flow technique were:

- i) The projected estimated cash flows with assumptions based on current available information including the length of the cash flow projection period and any residual or terminal value at the end of the cash flow projection period. The discounted projection cash flow can be based on a deterministic approach that use a single set of best estimate assumptions. Alternatively it can be based on a stochastic approach.
- ii) An adjustment for risk to reflect the inherent risk of the liability or asset due to uncertainty in the timing and/or amount of the estimated cash flow. This risk adjustment can take the form of either a risk margin included in the estimated projected cash flow or an adjustment to the discount rate.
- iii) The cost of capital representing the opportunity cost if having to hold additional capital over and above the fair value of the liabilities. Such capital is required to satisfy the insurance regulators to protect the client. The cost is mainly driven by the difference between the return available on these restricted assets and the return required by the entity to provide the capital.

As for the Pension liabilities – While immunization is an extreme approach to managed pension fund liabilities, I have recommended such a strategy in one pension fund I am involved with. To measure the quality of a matching strategy for a defined benefit pension funds under such a strategy using only fixed income investments, a best estimate cash flow projection of the pension liability is prepared and compared to the expected cash flow pattern of the investment portfolio. Different measures such as duration and discounted present value are computed to measure the resulting surplus or deficit. In such situations using the internal rate of return of the assets is the best discount factor to apply to the liability.

## Question 13

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

Assumption and Reinsurance Agreement – The source is the full description of the liabilities and the assets. A typical transaction would involve an actuarial consultant providing its own estimates and performing special sensitivity tests that the buyer would require. It is frequent that the buyer receives the full seriatim data of the liability and performs its own analysis.

As for the pension liabilities, the sources of cash flow projections are the consultant actuary for the liabilities and the portfolio manager for the assets.

#### 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 flow or the discount rate.**

Assumption and Reinsurance Agreement – as explained above we have used each of the techniques: adjusted cash flow, adjusted discount rate, deterministic scenarios and stochastic approach that uses an average of the probability-weighted multiple cash flow scenarios allowing for the guarantees and embedded options.

In the case of Pension liabilities the regulatory framework does not give much leeway to adjust for the perceived risk. The difficulties experienced in Canada over the solvency of these plans is for me a clear indication that they are not appropriate and should be modified.

#### Question 15

**Do you consider that a “risk free” rate should be used when estimating the current value of a future liability?**

The concept of risk free rate is a theoretical concept; something that does not exist in reality. With the very low level of current interest rate on government bonds, practitioners have some difficulty to apply the concept but it does not mean that its application was ever right. We can use different valuation approaches to measure the reasonability of some valuation results but the basis can't be something that does not exist; it can't be the foundation and the only element of foundation to establish a valuation. Many of the risks we try to measure today are dealt with from a theoretical point of view. For example, when we measure the risk of default on a bond in relation to its maturity we assume that the risk of default is something that is reduced over time while the reality is that we will find out about the default the day the money is due. Most likely the default on a bond that has 10 year of remaining life will be triggered by a cross default clause and the non payment of an instrument that will come to maturity tomorrow. The traditional measure of risk makes sense only for a well diversified portfolio among credit and maturity, not on a single bond.

Another illustration of the dilemma of credit risk is the one being raised in paragraph 29 : “ 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”. The reality is it should not affect the liability of the issuer, he is still obligated to pay the same capital; if I buy the share of that company I can't assume that the owner of the bond will accept a lower value, the real market does not give us such a break; “deep pocket” will have to pay the full amount while the liquidator or the regulator will not even consider this type of liability on the realization of the assets.

#### 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.**

Our company has a program of stock option; the accountants are strongly pressured to value these options using the Black and Scholes model. Among the assumptions in the basic model to value option we

assume the stock doesn't pay dividends during the option's life; the option is exercised on the expiration date and that interest rates will remain constant and known and that returns are normally distributed. I would argue that these assumptions are not in line with a stock option plan with a ten year horizon and a company that targets a 35% payout ratio. It is not because a formula is easily available that makes it adequate for every purpose.

According to their findings Scholes and Merton believed it is impossible to secure a risk free profit. Although there is arbitrage in certain market segments, these are not secure in the long run and relying on them violates the basic needs for the Black-Scholes to work.

While some updated versions of the model exist, people seems to forget that many of the statistical tools available can be used only under very specific conditions, especially the existence of a large sample, not a single event and more importantly, the behaviour of the participant is constant.

#### **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 providing inadequate. If so please give an example.**

When we value the price at which we are willing to assume a liability no doubt we assume a "profit margin"; I understand that some schools of thought want to consider that the "real value" of the liability should assume a zero margin.

One of our affiliates issues extended warranties for automobile mechanical parts; this product typically involves a single premium-paying contract such that the full premium (including built-in profit margins) is received on day one by the insurer. We are still arguing on how to value such business.

As for the argument that the 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, my preference would be to recognize the profit only during the life of the product not at the time of issue, but performing both calculations would provide better information. Front ending the profit may illustrate the volatility of some profit margin under certain assumptions.

#### **Question 18**

**If you use or are familiar with the Cost Approach, please indicate in your experience how the cost of fulfilling, transferring or setting/cancelling an equivalent liability is determined.**

Please refer to the answer for Question 12.

#### **Question 19**

**Do you agree with the Board's proposed approach?**

I agree that there is a need for standards or guidance on the valuation of liabilities in a wider context. I don't agree to exclude from the valuation practice for liabilities those arising from financial instruments. I don't agree with the view that not all liabilities should be within the scope of a future standard or guidance, it should explain rather why there is impossibility of standard.

I agree that it may be necessary to produce alternative definitions to enable the concepts to be more readily applied to the valuation of liabilities.

I agree that many approaches are applicable to the valuation of liabilities.

I agree that the market approach has little application to the valuation of liabilities.

I agree that the project should address the valuation of liabilities for any purpose and not address only the requirements of the financial reporting.