KPMG

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

KPMG ref: IVSC Comment Letter
The Valuation of Liabilties

Contact: Patrick Coady/Jim Calvert

May 3, 2013

Dear Sirs

Discussion Paper – The Valuation of Liabilities

We appreciate the opportunity to comment on the Discussion Paper *The Valuation of Liabilities* (the "DP") issued by the International Valuation Standards Council ("IVSC" or the "Board"). The following response expresses the views of KPMG's Global Valuation Services practice. We have set out responses to the questions raised in the ED in Appendix A with further comments in Appendix B.

We support the IVSC's efforts to provide standards and guidance to improve the quality and reliability of valuations. The IVSC has set out ambitious objectives for International Valuation Standards ("IVS") and other material it or its subsidiary boards propose to issue. It has positioned IVS to be at the centre of efforts to achieve high quality valuations, supporting the public interest in financial reporting and capital markets, bank lending, etc.

We believe that the valuation of non-financial liabilities, which are the focus of the DP, is an area of valuation which is less developed than the valuation of assets. As such, we believe that there is an opportunity for the IVSC to provide influential guidance. Such guidance, in order to be useful, will need to provide a comprehensive principles-based framework so that valuers approach such valuations in a consistent manner. The increasing use of illustrative examples in IVSC materials would enhance the guidance.

Please contact Jim Calvert at +353.1.410.1001 or Patrick Coady at +1 613 212 2841 if you wish to discuss any of the matters addressed in this letter.

Yours truly,

KPMG LLP

KPMG LLP

KPMG

Appendix I

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.

We agree that guidance on the valuation of a liability would be useful as this is an area with a lack of developed guidance.

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.

While IVSs are intended for broader application than just financial reporting, we note that a liability is defined in IFRS 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."

Where an item is defined for financial reporting purposes; we believe that it is preferable for IVS to use such a definition unless there is a specific reason why the definition is believed to be inappropriate for IVS. It would be useful to explain any differences between the definition in IVS and the definition in financial reporting, so that valuers and users can understand the practical effects of such differences.

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

We agree with the exclusion of financial instruments from the scope of this project, since the value of a liability held by a counterparty as an asset can generally be established based on the value of that liability as an asset to the counterparty.

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 other guidance exists in relation to the measurement of these items and/or other guidance has been issued by specialized organisation and as such these liabilities should be excluded.

In addition, we note that these items are not carried at fair value for financial reporting purposes. As such, one of the key circumstances that often gives rise to the requirement to value certain liabilities does not apply to these items.

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 believe that guidance on the valuation of contingent liabilities should be included. We note that IFRS 3 requires that contingent liabilities be measured at fair value, which is another reason why guidance would be helpful.

We note that certain financial liabilities, such as derivatives, may be regarded as contingent. Therefore, the inclusion of contingent liabilities in the scope of the guidance may be inconsistent in some circumstances with the exclusion of financial liabilities. As such, the exact scope should be clarified.

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

Valuations of litigation liabilities may be required in certain circumstances, e.g., for financial reporting purposes. As such, it would be useful for the IVS to consider best practices for the valuation of such items. By outlining best practices for such items, the facts and circumstances in a particular case can be assessed to determine whether a liability can or should be valued. It would also be useful to clarify the difficulties associated with valuing litigation liabilities.

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

We are most familiar with valuations of liabilities for financial reporting purposes. In addition, liabilities may be valued as part of a broader negotiation of contractual terms between parties. Other purposes include litigation and property valuation.

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

We normally encounter fair value for financial reporting purposes, i.e., market value under IVS.

In many circumstances, liabilities are not carried at fair value for financial reporting purposes but based on specific requirements in accounting standards. We do not think that other measurement attributes represent other bases of value that should be considered by the IVSC.

We have also seen liabilities valued for fair market value purposes (e.g., tax valuations in the United States).

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?

We agree that the valuation of liabilities can be addressed by one of the three categories described in the IVS Framework.

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.

We believe it is best if the same definition could be used for both assets and liabilities.

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.

The market approach as applied to value deferred revenue consists of a top down approach that considers standalone pricing of performance obligations, when available. [Other approaches are also used to measure deferred revenue.]

As actual transactions pertaining to most non-financial liability on a standalone basis are rarely observed, a direct market approach is often difficult to apply.

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.

Examples include asset retirement obligations, deferred revenue and contingent consideration.

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

Management estimates or engineering studies

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.

A risk adjustment is sometimes reflected in the assumed profit margin that a market participant would charge to assume the obligation. For example, a transferee who assumes an obligation where there is a significant risk that the cost to meet the liability will turn out to be more than expected will charge a higher margin. A risk adjustment could also be considered in the selection of the discount rate depending upon how the cash flows were developed and the extent to which risk has been incorporated.

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.

We do not believe that the risk free rate should be used in estimating the fair value of a liability unless certainty equivalent cash flows are used, which we believe is rare. For financial reporting purposes, the most frequently used technique is conditional cash flows (i.e., as under the discount rate adjustment technique) and less frequently probability weighted expected cash flows. We do not see use of risk neutral cash flows outside of option pricing and similar models.

We believe that there is diversity in practice in how discount rates are derived for the valuation of liabilities. We feel that the discount rate must include the risk of non-performance. We also believe that the build up of the discount rate will depend on whether or how a profit margin has been applied

The cost of secured and unsecured debt, the cost of equity and the WACC may be a good starting point depending on the nature of the liability and the risk profile (e.g., how the risk of the subject liability compares to the risk of the underlying business).

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 have not seen the option pricing method used to value non-financial liabilities. We have seen scenario analysis considered, but the ability to define scenarios depends greatly on facts and circumstances.

We have seen option pricing models used to value contingent consideration in a business combination though there is controversy in how such models are applied in practice.

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.

We agree that such a margin is appropriate if a market participant would apply such a margin. We believe that a transferee who assumed the risk of adverse price changes would generally want to be compensated for bearing that risk through an increased margin. Such a cost mark-up is common in the application of the income approach to value deferred revenue.

If the liability involves an obligation to render a service, a profit margin on the cost to render the service must be included (e.g., when deferred revenues are valued, the cost to fulfil plus a margin is applied)

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.

One factor is considering the profit margins of entities who undertake such activities. However, such margins may not include margin for bearing the risk of price changes over time, as outlined in 17. We would refer to such a method as an income approach and not a cost approach.

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

Notwithstanding the guidance section in IFRS 13 there remains uncertainty for the valuation of liabilities that are not traded in markets. As such, guidance from the IVSC would be useful.

We believe that it is important that where the IVSC adopts a different approach than that followed in IFRS, it should be fully explained.

Appendix 2

Para #	*Comment*
2	We suggest removing the phrase "that may be measured in monetary terms."
5	Consider replacing "extinguished" with "removed" or "reversed".
8	This paragraph states that deferred tax liabilities would be excluded on the same basis that lease obligations would be excluded, i.e. that there is a defined payment on a specified date or dates in the future. While we agree that it should be excluded we think it should be excluded on the basis that a deferred tax liability is an accounting calculation that is calculated using accounting rules.
10	Is it intended that the project scope would cover liabilities arising under deferred revenue arrangements? Such obligations are an issue in valuations performed for financial reporting purposes in certain industries. "Warrantees" is misspelled.
20	Suggest altering language to state that market and income approaches would be most common in the valuation of liabilities.
22	We suggest removing the phrase "a holder of a liability would rationally seek to mitigate or eliminate or liability..." Some entities may prefer to hold the liabilities as opposed to utilising resources to extinguish them; the point is that they want to pay as little as possible to pay another party to take on the liability however.