DUFF & PHELPS

IVSC

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Response to IVSC Discussion Paper Valuation of Liabilities

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General Observations

We appreciate the IVSC's efforts to provide guidance on the topic of Liabilities. We have the following general observations on the Discussion Paper (DP), grouped by theme:

Purpose of the Guidance

While we understand that the goal of the IVSC generally is to provide broad guidance not specific to any area of valuation, we find that the lack of a stated purpose (specific valuation applications) greatly hinders the objective of the document. Without laying out the specific purposes for which the valuation of liabilities is contemplated, the discussion in the paper is (and would remain) mostly academic and is of limited practical relevance.

Scope & General Recommendation

We find that many types of liabilities are left out of the proposed scope of the paper. This, in combination with the lack of specific purpose for the guidance, leaves what we see as two sets of liabilities:

(1) Warranties, AROs (decommissioning obligations) and contractual liabilities for which there is guidance or where practice is generally not diverse; and

(2) Environmental liabilities and liabilities arising from contingencies, which currently lack adequate guidance and practice is quite diverse.

If the IVSC wishes to provide guidance on the valuation of liabilities for a wide variety of purposes, we recommend that it identify the types of liabilities for which suitable valuation guidance exists outside of IVS and refine the scope of the IVSC's project to:

a) provide references to suitable guidance and resources resident elsewhere that its constituents can apply for particular liability valuation purposes, and
b) focus its own guidance on areas for which no guidance exists and is not being developed elsewhere, or where there is diversity of practice.

We recommend that the IVSC is broad and inclusive in its effort to define the scope, but not by way of stating that it aims to provide guidance for valuations for any purpose, but rather by exploring a broad array of specific purposes.

Technical Recommendation

There is no discussion of whether cash flows related to liabilities should be analyzed on a pre-tax or after-tax basis, which is an important issue that should be addressed, in addition to the determination of discount rates.

Additionally, we recommend that the IVSC provide various examples of the application of any ultimate guidance on liabilities.

* * *

Subject to our comments above we have provided responses to the specific questions posed in the Discussion Paper.

Responses to Specific Questions

Questions

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.

Duff & Phelps response: Please refer to our General Observations in the beginning of this letter.

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.

Duff & Phelps response: The definition can be improved further. For example, it is not clear whether the obligation is future or present; whether it arises from past, present or future events; or more generally, where the line is to be drawn to distinguish a liability from an expense. Similarly, it is not clear in the definition how a liability is different from an executory contract.

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

Duff & Phelps response: To the extent that financial instrument valuation requires specialized expertise, and the IVSC has other projects focused on financial instrument valuation, we agree that such liabilities could be excluded from the scope of the liabilities project, provided that the valuation of financial liabilities will in fact be covered by the project on financial instrument valuation. See also the General Observations in this letter on providing the IVSC's constituents with references as to where to locate relevant guidance on the subject.

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

Duff & Phelps response: Please see our earlier comments on the scope of the guidance. Furthermore, scope issues need to be examined in the context of who the users of the guidance will be and the purpose of the guidance.

For example, for what purpose(s) would pension liabilities be valued by constituents? Does relevant guidance already exist for such purpose(s)? If so, where can it be located; if not, this could be an area for inclusion in the scope provided that the IVSC has or can secure the technical expertise to develop this area.

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.

Duff & Phelps response: In addition to the contingent liabilities discussed in the paper, valuations of guarantees and indemnifications (other than those arising under a financial instrument) are also common.

Also, a few of the liabilities listed in paragraph 10 of the DP have inherent contingent elements, and limiting the scope of the IVSC guidance to exclude contingent liabilities in general would leave very few types of liabilities on the table.

At the same time, since The Appraisal Foundation in the U.S. has recently formed a working group to address the valuation of contingent consideration, the IVSC would be well advised to coordinate any efforts with TAF in this area, and for contingent liability valuation in general.

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

Duff & Phelps response: Litigation liabilities can be and are valued for litigation strategy (or settlement negotiation), financial planning, and M&A purposes. It is less common to value litigation liabilities for purposes that might entail public disclosure, such as for financial reporting. Also, different hurdles may exist for their recognition, measurement or disclosure depending on the purpose of the valuation.

For example, for financial reporting purposes in a business combination, a contingent liability would be recognized at fair value if “fair value is determinable” (U.S. GAAP) or if it is a “present obligation” and is “reliably measurable" (IFRS), all of which are accounting determinations. On the other extreme (as an example under U.S. GAAP), when the indemnification of the outcome from pending litigation is provided in, for example, a spin-off, for financial reporting purposes that contingent liability would be recognized at fair value.

Guidance on the valuation of litigation liabilities would therefore need to be considered in light of its purpose and the needs of its users, while also understanding the nature and limitations posed by any privilege concerns of outside and in-house counsel, and any legal consequences.

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

Duff & Phelps response: These include financial reporting, tax, M&A (in connection with transaction pricing when, for example, material environmental liabilities, warranties and contractual obligations may be present), solvency opinions, ordinary course of business (for management planning and analysis) and dispute.

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

Duff & Phelps response: It depends on the context of the valuation. The bases we see include the following (note that some of these are not bases of value per se, but alternative perspectives on value and risk, for lack of a better term):

- Fair value (financial reporting and M&A). Note that the Fair Value references we have used in this letter relate to IFRS 13 *Fair Value Measurement*.

- Fair market value (tax) (Note: this is not the same Market Value as defined in IVS, particularly in light of the recent amendments to IVS). Fair market value that we have referred to in this letter is a U.S. jurisdictional term, and presumably, liability valuations are performed in other jurisdictions for specific regulatory purposes under specific (and similar) definitions of value.

- Expected value (management planning, dispute, and some financial reporting contexts). Expected value is a probability-weighted value.

- For contingent liabilities for which only a range of possible losses can be estimated, in some circumstances under U.S. GAAP the minimum amount within the range may be recorded.
- For contingent liabilities in a planning/strategy context, management may also be interested in gaining an understanding of the risk profile or looking at a sensitivity analysis.

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?

Duff & Phelps response: Generally, yes; however, there are additional considerations:

- Market Value is similar in concept to fair value (IFRS 13), in that the liability is presumed to be transferred (that is how we interpret the IVSC's recent amendment to IVS). In that sense, Market Value may be appropriate in a number of circumstances, as discussed throughout this letter. However, any differences between Market Value and IFRS 13's fair value should be thoroughly analyzed and understood before concluding that the two bases of value are interchangeable.

- Fair Value (IVS) definition may be applicable in specific jurisdictional contexts that require the respective interests of the transacting parties to be reflected in the price for the liability.

- Investment value may be similar to expected value.

- Special value may not seem to apply at first blush, although it is conceivable that a company might pay a slight premium over the expected value of a litigation, due to the desire to settle a litigation matter for particular reasons.

Separately, we think that the common labels that some IVS definitions share with definitions used for specific valuation purposes (e.g., Fair Value (IVS) vs. Fair Value (IFRS 13); Market Value (IVS) vs. Fair Market Value (U.S. tax term)), which have distinct meanings despite the similarity implied in the label, may cause confusion in practice, especially as it relates to liability valuation.

10 Do you agree that it may be necessary 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

Duff & Phelps response: In general we do not support a proliferation of definitions, including specific definitions for bases of value exclusive to liabilities. We would prefer that any incremental guidance be provided through the interpretation of existing definitions and their application to liabilities.

Furthermore, the definition of what constitutes a liability in the first place may differ depending on the purpose of the valuation.

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.

Duff & Phelps response: A few types of liabilities are actively traded, for example Contingent Value Rights (CVRs), and the market approach can be used to value these. In general, the commercial insurance market can be used as a benchmark for the cost of transferring a contingent liability to a market participant when there is not an observable market for such transfers.

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.

Duff & Phelps response: These include DCF valuation of:

- contingent consideration for financial reporting or M&A decision-making purposes;
- licensing agreement payments for financial reporting, ordinary course of business or M&A purposes
- warranties for financial reporting, ordinary course of business or M&A purposes;
- environmental liabilities for financial reporting, ordinary course of business or M&A purposes;
- pending litigation for financial reporting, ordinary course of business or M&A purposes

- guarantees and indemnifications on tax uncertainties, litigation expenses and outcomes, environmental issues, lease obligations, investor returns, portfolio losses, volume commitments, schedule and customer service obligations, deferred compensation and other liabilities for decision making and financial reporting purposes.

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

Duff & Phelps response: The sources for the inputs to the DCF include historical company or industry data, management assessments, independent expert assessments, and market-derived information (e.g. for cost of debt or equity, historical volatility, market pricing of risk, and the cost of transferring a liability to an insurer).

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.

Duff & Phelps response: Best practice is to reflect material quantifiable uncertainty in the cash flows (use expected (probability-weighted) cash flows). The discount rate will generally reflect the time value of money and, depending on the purpose, the entity's risk of non-payment or other market-priced risks. To the extent that the uncertainty is correlated with the market (i.e. there is non-diversifiable systematic risk, for example for contingent consideration tied to revenues or profits), it may be appropriate to adjust the discount rate accordingly.

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.

Duff & Phelps response: We do not believe that a risk free rate is appropriate. See response to Question 14. Even if the beta of the cash flows is zero, the discount rate should reflect the credit risk of the obligor.

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.

Duff & Phelps response: We have used option pricing methodologies in measuring the fair value of liabilities only for financial reporting purposes. This situation arises frequently, for example, in valuing contingent consideration with minimum targets or caps on payments. We have encountered both traditional Black-Scholes option pricing models and real option pricing models in this context.

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.

Duff & Phelps response: Whether a profit margin (on the effort incurred to fulfill the liability) is included or not might depend on how the liability would be fulfilled – e.g., it could be outsourced or be fulfilled in the ordinary course of business (even though entities may implicitly consider the related profit margin in deciding how to best deploy their resources). The manner of fulfillment would also drive other assumptions.

Whether a profit margin is included or not also depends on the premise of value. If the premise of value is that the liability is transferred to a third party, then a profit margin for the relevant third party might be included. On the other hand, if the premise of value is an orderly transaction between market participants and there is a natural market, then a profit margin might not be included. For example, for contingent consideration the relevant market may be the M&A market. In this case, the fair value of the contingent consideration liability would be the same as the fair value of the contingent consideration asset – i.e. it generally would not include a profit margin.

Finally, it is important to re-emphasize that, if there is uncertainty as to the cost estimate, the cash flows used to value the liability should be the probability-weighted (expected) cash flows, not a single scenario that might prove inadequate.

We also note that this question confuses the notion of a "profit margin" with that of a "risk premium". See our comments to paragraph 33 in the next section of this letter.

On the issue of how to consider various risk factors (addressing the risk premium aspect of this question), see our response to Question 14.

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.

Duff & Phelps response: This would largely depend on the way the liability would be fulfilled, also given the basis of value required in the valuation. Also please see our response to Question 17.

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

Duff & Phelps response: We disagree with the proposed approach for the following reasons:

- The valuation of liabilities for financial reporting purposes should not be excluded by default from the IVSC guidance, especially since this is the most common purpose for which liabilities are required to be valued, as acknowledged in the DP. Please refer to our earlier comments on defining the scope for the IVSC guidance in the General Observation section of this letter.
- Summarizing the requirements in IFRS 13 may lead to inadvertent errors (for example, see our comment to paragraph 38 of the DP). In addition, the guidance in IFRS 13 may continue to evolve, and pertinent updates may not be captured adequately. Therefore we recommend that any references would be limited to pointing to IVS 300.

Additional Comments by Paragraph

Paragraph 2

The reference to “monetary terms” is not immediately clear. Par. 6 explains what the intended meaning is; this explanation should be provided when the term is first used.

Paragraph 6

The reference to the “holder” of the liability is not clear. From the context it appears that reference is made to the obligor; however, the meaning should be clarified here and elsewhere. Preferably use a different term.

Paragraph 23

The paragraph makes the following statement:

> “For some types of liability there may be no market into which a transfer could be negotiated at any price..”

In reality, the commercial insurance market serves as a backstop for many liabilities.

Paragraph 23

Clarify if settlement is assumed to occur at the valuation date or over time.

Paragraph 24

It is not a requirement that the liability be “actively traded” in order to apply a Market Approach.

Paragraph 29

We agree that most of the risks associated with a liability are better reflected in the cash flows than in the discount rate. However, it is not true that systematic and market risks are always of little relevance to the valuation of a liability. Contingent consideration, licensing payment obligations and other contingent liabilities tied to business performance (such as guarantees on returns) are examples of liabilities for which systematic risk is present (i.e. the beta of the cash flows is not zero).

Paragraph 32

The Cost Approach may occasionally be applicable in the valuation of liabilities in that a liability may be associated with providing a particular service, performing certain remediation activities, or procuring certain equipment, at a future date. It is conceivable that depreciation could enter into the calculations, for example if the entity has an obligation to provide a specific asset at a future date (at which point it will be worth less than it is today).

Furthermore, banks may use this approach for some financial instruments in estimating the cost today to replace or replicate a liability (although financial liabilities are proposed to be scoped out of this project).

Paragraph 33

This paragraph and Question 17 seem to confuse the notions of a "profit margin" and a "risk premium". A profit margin is earned on the fulfillment effort related to satisfying the liability, whereas a risk premium reflects compensation for accepting the uncertainty related to the cash flow estimates for the fulfillment activity.

Paragraph 38

The statement that *any* liability acquired in a business combination has to be measured at fair value is incorrect. For example, a contingent liability would only be recognized at fair value under IFRS if it is a "present obligation" and is "reliably measurable".