RE: Comments on Discussion Paper – Valuation of Liabilities

Dear Sirs/Madams,

Organismo Italiano di Valutazione (“OIV”) is pleased to submit to The International Valuation Standard Council its comments on the Discussion paper “Valuation of Liabilities”.

OIV apologises for the delay in submitting its letter of comment, determined by the schedule of its consultative bodies.

OIV is the Italian valuation standard setter. OIV is a foundation established by professional associations (chartered accountants and accounting experts, financial analysts, chief administrative and financial officers), Borsa Italiana (the Italian Stock Exchange), Assivrevi (the Italian association of independent auditors) and Università Bocconi. OIV intends to advance the dissemination of valuation standards and guidelines consistent with International Valuation Standards (“IVS”). OIV’s valuation standards reflect the specificities and peculiarities of the Italian business landscape.

Our comments are outlined below.

Project Scope – The use of “not defined” may create a conceptual problem due to the choice of words. This might be avoided by replacing “not defined” with “uncertain” or “not known” or “exposed to uncertainty”.

Explanation. The statement that the liabilities considered “are not a defined payment” (par. 7) or that “the cost of the obligation is not defined” clearly means that the liability payoff is exposed to uncertainty (sometimes of a very complex type). In fact, while something that is not defined cannot be valued, that which is uncertain can be valued (this falls within the scope of the economics of uncertainty). There must be some kind of contract that defines the obligation to be fulfilled (“specific under contract or a law”) by or at a future date. The definition should make it possible to determine, by or at the agreed future date, whether the obligation has been fulfilled. In that circumstance the cost X of the obligation (payoff, monetary value of the obligation) will
be known. Before fulfillment X is an uncertain variable. The problem of valuation is to value X 
ex-ante.

For example, in valuing the obligation to remediate a contaminated industrial site, it is 
necessary to define clearly, by contract, the level (the quality) of remediation required and the 
deadline for the process. The cost X of restoration will be uncertain ex ante, also because it 
might be “contingent on a future event”, or “contingent on future events” (the trigger event can 
take place in different ways). However, ultimately it is necessary to determine whether the 
obligation has been fulfilled. If the definition leaves margins of imprecision, X will be treated as 
the minimum X permitted by the definition.

In conclusion, ex-ante X can be very uncertain; however, the criterion with which X will 
be measured ex post needs to be well defined, before or at the valuation date.

Par. 29 – With the statement “the risks associated with a liability are better reflected in the 
cash flows than in the discount rate”, it would be worthwhile to add that there are (at least) 
two ways to incorporate risk-adjustment in the cash flow: 1) the option pricing method, i.e. 
the method of risk-neutral probabilities and 2) the method usually referred to as the 
“actuarial method”, or adjustment of the expected cash flow by risk loading.

Par. 30 – In reading this paragraph the reader might develop the impression that techniques 
such as options pricing (OP) and Monte Carlo simulation (MS) are conflicting or mutually 
exclusive. The citation of the two approaches should be changed slightly to avoid this 
misunderstanding.

Comment. The application of both OP and MC require the specification of the initial probability 
distribution (stochastic model). MC is a numerical technique that permits the application of assumptions (the model) in case these are too complex to be managed with closed form solutions. From the point of view of uncertainty, while it is true that MC produces random draws (though, for the sake of precision, they should be called “pseudo-random”), the draws are made from the probability distribution incorporated in the assumptions underlying the model.

Par. 33 – The reasoning on profit margin is slightly puzzling. Perhaps the wording should be 
revised. If profit margin “should not be confused with the profit margin that would be expected 
by any contractor …”, why call it profit margin? It seems for all intents and purposes a risk premium, as noted clearly in Question 17. Thus, to answer the question, we agree with the
inclusion of this “margin” or premium, which is consistent with the considerations made previously on the risk adjustment of discount rates and cash flows.

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We hope that this submission is helpful to you. If you have any questions regarding our comments, please do not hesitate to contact Mauro Bini – Management Board’s Chairman OIV (mauro.bini@unibocconi.it).

Best regards,

Prof. Mauro Bini