DUFF & PHELPS

International Valuation Standards Board
41 Moorgate
LONDON EC2R 6PP
United Kingdom

December 24, 2010

Reference: Discussion Paper: *Valuation Uncertainty*

Duff & Phelps appreciates the opportunity to provide comments on the above referenced discussion paper requested by the Board. Our observations and responses to specific questions are provided in the attached document.

We would be pleased to further discuss our comments with the International Valuation Standards Board and staff. Please direct any questions to Paul Barnes in our Philadelphia office at (215) 430-6025.

Sincerely,

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Services and Office of Professional Practice

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IVSC

Response to Discussion Paper:

Valuation Uncertainty

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General Observations

Our general observations on the Discussion Paper (the Paper) are as follows:

- The Paper would benefit from a clear statement as to its intended purpose. As presented, the Paper seems largely theoretical and it is not entirely clear if it is intended to address valuation uncertainty related specifically to financial reporting or for other general valuation purposes. If the Paper is intended to focus on financial reporting (as certain references seems to imply), we question its timing and purpose. As the IVSB is aware the IASB and FASB (the Boards) are currently addressing the issue through their joint project on Fair Value Measurement.

    In summary, as of the date of this letter, the Boards have tentatively decided to require an entity to provide the following information about Level 3 fair value measurements:

    1. A quantitative disclosure of the unobservable inputs and assumptions used in the measurement;
    2. A description of the valuation control processes in place; and
    3. A discussion of the sensitivity of the fair value to changes in unobservable inputs and any inter-relationships between those inputs that magnify or mitigate the effect on the measurement.

    The Boards also tentatively decided to perform further analysis on the operationality of a measurement uncertainty analysis disclosure that provides a range of fair values (exit prices) that could have resulted from the use of other reasonable unobservable inputs in the fair value measurement. This analysis will constitute a separate part of the fair value measurement project to be finalized after completion of their respective standards.

  The manner in which the Boards' tentative requirements above will be implemented in practice are yet to be seen. These requirements will be in addition to the existing ASC 820 requirements (and part of the soon-to-be-issued IFRS on Fair Value Measurement) to provide a description of the valuation technique(s) and the inputs used for Level 2 and 3 fair value measurements.

  Therefore, the financial reporting authoritative literature already includes or will include uncertainty-related disclosures that have been proposed, deliberated and finalized in an open due process, and will be enforced by the audit profession and the financial reporting regulatory authorities. It is not clear by what means any potential incremental disclosures recommended by non-authoritative bodies would be enforced in practice.

Further, we note the absence of any references to U.S. GAAP in the Paper. It is not certain that IFRS will be adopted in the U.S. at this time and if so when that might occur. We think it prudent to include U.S. GAAP references until such time that they become obsolete.

- The Paper seems focused primarily on financial instruments, rather than intangible assets. For example, the Paper frequently refers to markets and the derivation of inputs there from. Meanwhile uncertainty is even greater in situations in which no observable markets exist and the assets are not traded on a standalone basis (albeit they may be traded as part of a group).
- The conclusion that, to avoid bias or excessive subjectivity, a disclosure of the identity and experience of the valuer is more important than disclosure of the effect of different valuation assumptions would not be workable in the context of financial reporting for U.S. GAAP purposes. This type of disclosure would raise the issue of expertization (naming the expert in the company filing with the regulatory body, in this case the SEC) and carries with it certain legal implications. In the context of financial reporting in the U.S., the role of the valuer is in essence to assist management in arriving at a conclusion that will be reported in management's financial statements and valuation practitioners are rarely, if ever, publicly disclosed or referenced in connection with valuations for financial reporting purposes.
- We believe that an alternative approach to distinguishing between *risk* and *uncertainty* is to recognize that a measure of *risk* has an associated probability distribution, providing a framework for such risk assessment. *Uncertainty* arises where no, or limited, data exists to infer a probability distribution, increasing the reliance on the professional judgment of the valuer.

  In light of this, we believe that making a distinction between uncertainty and risk (including market risk) may not be productive, and the Paper should *address both risk and uncertainty disclosures, together*. Also consider that par. 30 of the Paper states the Board's view that "it is inappropriate to assume that material uncertainty only affects assets valued in Level 3". This implies that the Board believes (material) uncertainty could arise at least in Level 2 as well. There are usually markets for Level 2 assets, and valuation inputs are derived from such markets, therefore (market) risk, or risk with a known probability distribution is a pertinent concept in this case as well. In other words, the statement in the Paper that uncertainty should not focus on Level 3 assets only runs counter to the distinction currently made between (market) risk and uncertainty, and Paper's focus solely on uncertainty.

- We believe the Paper should differentiate between *uncertainty* and *sensitivity*, as the two concepts have similarities that make them easy to confuse. Uncertainty ultimately focuses on the point estimate of the valuation conclusion given a (reasonable) band that typically brackets such conclusion. Sensitivity in turn portrays the changes in the valuation conclusion as a result of varying one or more inputs.
- We disagree with the statement that "a valuation… is an estimate of the most probable of a range of possible outcomes based on the assumptions made in the valuation process" (par. 4). In corporate finance, valuation represents the expected value associated with a range of possible outcomes. The same holds true for a market price, which is the present value of the expected dividend stream and capital gains.
- We disagree with the insinuation that hindsight is taken into account in a valuation performed as of a past (historical) date (par. 12.2). While hindsight may confirm the validity of the inputs used, a fundamental principle of valuation is that the analysis is to be performed with the information known or knowable as of the valuation date, and without the use of hindsight. A valuation incorporates expectations about the future as of the valuation date, rather than a 20-20 look back to the valuation date.
- We observe that when uncertainty is assessed without proper correlation of interdependent inputs the degree of uncertainty may be not only be overestimated but could be *underestimated* as well (par. 19 only focuses on overestimation). This in particular was a key contributing factor to the impact of the mortgage meltdown. For example, the valuation of subprime-mortgage-backed CDOs did not take into account the correlation of the assets; specifically, the situations under which one subprime mortgage would perform poorly were the same situations under which many of them would perform poorly. Instead, the (faulty) assumption was made was that the portfolio was diversified.

* * *

Subject to our comments above we have provided responses to IVSB's specific questions.

Responses to Specific Questions

Question 1: *Do you agree that it is only when material, or abnormal, uncertainty attaches to a valuation on a specific time or date that that specific disclosure is necessary when the valuation is reported? If not please explain why you consider that an uncertainty statement should be provided in all cases.*

Duff & Phelps response: The reference to “abnormal” introduces complexity as the preparer would have to gauge “normal” from “abnormal” variations. Further, “normal” becomes even more difficult to ascertain in situations where the asset is unique or there is no market for the asset. It would be more useful to anchor any potential disclosure around *materiality* regardless of the source or characteristics of any variations.

Question 2: *Do you believe that the Board has identified all major sources and types of material valuation uncertainty? If not please identify what additional causes of uncertainty exist and how often you encounter these in practice.*

Duff & Phelps response: The list included in the document appears quite comprehensive. However, we do not believe it is appropriate to combine uncertainty arising from the valuation process that is *external* to the subject asset (e.g. experience of the valuer) with any *intrinsic* uncertainty arising from the attributes of the subject asset. It is presumed that the valuation is performed in an unbiased, objective and informed manner and that the appropriate judgments have been made.

Question 3: *Do you agree with the Board’s conclusion that an explanation of any abnormal uncertainty identified and an explanation of the impact this has on the valuation (a qualitative statement) is more helpful to users in understanding the valuation than a purely numeric expression of the range of possible values created by the uncertainty (a quantitative statement)?*

Duff & Phelps response: We agree (however, please see our comments on Question 1 in reference to “abnormal”). We also believe that providing a qualitative discussion of why the specific inputs were chosen in preference to other inputs (on a relevant asset grouping level, where appropriate) could provide sufficient information about the rigor applied in estimating fair value. The issue of providing a quantitative disclosure to accompany a qualitative disclosure is one of practicality: often a valuation would include multiple assets across various asset classes giving rise to aggregation issues.

Aggregating ranges of quantitative disclosures across multiple assets and asset classes could produce results that are meaningless. For example, in the context of a portfolio of financial instruments, it is unlikely that all instruments would be settled at the top (or respectively, the bottom) part of the range. Thus, the pragmatic solution seems to be to provide a robust qualitative discussion about the inputs used (many aspects of this are already required by ASC 820 in U.S. GAAP and in the soon-to-be-issued IFRS on Fair Value Measurement).

Further, we believe that a quantitative statement (range) on its own, without a qualitative explanation, is not helpful and would tend to raise uncertainty in the disclosures themselves. Further, it would have the undesirable effect of casting doubt on the valuation conclusion, which was judged to be most appropriate in the facts and circumstances. Also see the response to Question 5.

Question 4: *Do you think the IASB should include an explicit requirement in the proposed IVS 105, Valuation Reporting, to disclose any material uncertainty or is the principle that requires valuation reports not to be ambiguous or misleading sufficient?*

Duff & Phelps response: No, an explicit requirement is not needed. As stated earlier, depending on the purpose of the valuation, disclosure requirements around valuation uncertainty may already exist (as may be the case for valuations for financial reporting). Further, the mechanism by which any incremental disclosure requirements resident in IVS may be enforced is not established at the moment.

Question 5: *Do you consider that there are cases where a qualitative statement of the causes and impact of uncertainty on the valuation is inadequate and should be either augmented or replaced by a quantitative statement? If so please*

a. state the circumstances and assets classes where you believe that quantitative statements are more helpful to users and,

b. provide a brief explanation or example of the type of quantitative statement that you believe would be useful.

Duff & Phelps response: Ideally, a qualitative statement could be augmented (but not replaced) by a quantitative statement. However, there are practical issues surrounding this approach that arise from the number of assets and asset classes included in a valuation report. There is a cost-benefit consideration in providing information on a more granular level (and for certain types of assets there may be competitive reasons that could preclude divulging certain information)[1]. By aggregating, however, a quantitative disclosure may lose its meaning and usefulness, which is also a function of the types of assets involved.

For example, in the fixed income markets, it has been standard practice to perform sensitivities on various inputs (e.g. changes in interest rates, prepayment rates, default curves, etc.). This being an established practice, together with the types of (macro) inputs considered in the sensitivities which may impact multiple fixed income products in a similar fashion, makes the measurement uncertainty disclosure relatively less problematic and meaningful on an asset class level. However, this approach loses its effectiveness with multiple equity securities: the use of non-homogeneous inputs across the investments may lead to potential aggregation issues in disclosure (i.e. aggregating end ranges of dissimilar items).

An additional implementation issue relating to an incremental quantitative disclosure, even with respect to a single asset, is the potential subjectivity in the magnitude of the range of uncertainty that would be disclosed around the valuation conclusion, unless the range is required to address a specified section of the probability distribution, or alternative scenarios are expressly defined. This is not an approach we would recommend as it introduces the potential for a series of bright lines in disclosure. Further, it is not always true that a preparer would focus on the central part of the distribution: for certain guarantees, warranties, options and complex derivatives, the entire valuation may at times revolve around the likelihood of low probability, high impact events.

As to approaching an incremental quantitative disclosure by describing it qualitatively (e.g., disclose a likely or reasonable band of valuation conclusions), there is a rich literature in psychometrics on the different meanings of qualitative terms (possible, likely, probable, etc.) to different people. The same arguments apply to basing the valuation uncertainty analysis on "reasonable and likely alternative assumptions" (par. 19) and their impact on the valuation conclusion. Thus the task of both describing and measuring valuation uncertainty is likely several orders of magnitude more difficult than estimating fair value of assets that are not traded.

[1] This cost-benefit consideration affects not only potential quantitative uncertainty disclosures, but any qualitative disclosures as well. The discussion paper's suggestion in par. 19 that a disaggregated asset-by-asset uncertainty measurement should complement a portfolio analysis may not be practical to apply.

In summary, we believe that augmenting qualitative statements with quantitative disclosures is not practical across all asset classes and in all valuation circumstances, and will be prone to diverse interpretations in practice.

Question 6: *Do you consider that it would be helpful if IVSC developed guidance on methods for making a quantitative disclosure of uncertainty under specific circumstances? If so please indicate the circumstances and any methods that you either use or encounter in your market.*

Duff & Phelps response: Please see our response to Question 5.