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International Valuation Standards Council
By email: **comments@ivsc.org**

11 February 2019

Dear Sirs

Non Financial Liabilities IVS 220 Exposure Draft

We have noted with interest the publication of the above exposure draft and the invitation to submit comments.

We are pleased to see that the Board has resurrected the project to include material specific to the valuation of liabilities within the IVS following a four year hiatus. While the valuation of liabilities has been implicitly covered by the standards for many years, the Standards Board had previously recognised the need for the standards to include guidance on the particular properties and characteristics of liabilities and the implications this had for their valuation. Following the issuance of IVS 2011 it announced a project to examine the need for such material and what should be included in its scope. A Working Group consisting of three Board members and a similar number of invited expert practitioners was established.

After approval by the Board, a Discussion Paper was issued in early 2013 on which views were sought. This is briefly referenced on p6 of the preamble to the current draft. We note that this discussion paper and the responses to it have been moved to the "Archived Consultations" section of the website. We suggest that since the project has been resumed these documents should be moved back to the "live" page for the project in the interests of transparency.

The Board considered the responses to that Discussion Paper and, in 2014, approved a brief for the Working Party to develop a draft standard. However, the project was then put on hold pending a reorganisation of the Board structure.

During 2013 and 2014 the Board also engaged in active liaison with the International Actuarial Association, as both organisations had identified an overlap between the activities of their respective constituents and the benefits of as much consistency as possible in their respective announcements. We are therefore pleased to see from the "Ancillary Markets" section of the preamble that there appears to have been continuing contact between the organisations.

While we welcome the intention to introduce a new standard providing guidance on valuation considerations for liabilities that differ from those for assets, we are disappointed to note that many of the conclusions reached following analysis of the responses to the 2013 Discussion Paper have not been carried through into the draft. We also note that some findings in the preamble to the draft have not been reflected. We explain these further in our comments on each section of the draft attached to this letter.

Yours faithfully,

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Comments on IVSC Non-Financial Liabilities Draft

Para in Draft	Comment
General	**Positioning /Taxonomy:** The proposed numbering as IVS 220 implies that this is a part of a group of standards focussed on business valuation, along with the existing IVSs 200 and 210. While liabilities are frequently encountered in business valuation, and this standard has been prepared by the BV Board, they also commonly arise in relation to real estate. Two examples are: • environmental clean up liabilities which can be transferred with an interest in land and not just as part of a business • liabilities for repairs or reinstatement under a lease of real property, which can be transferred with the lessee's interest. The standard would benefit from being given a wider perspective to clearly include such liabilities and methods for their valuation and from not being presented as being solely a business valuation issue.
General	**Title and Scope:** We consider the proposal to focus this standard on "non-financial" liabilities to be a mistake. In the discussion paper (DP), which was issued by the Standards Board in 2013, comments were sought on how liabilities generally should be covered in the IVSs. In particular views were invited on the definition of a liability and the scope of any new standard. While a simple definition of a liability had been floated by the Board, more respondents opposed this than agreed with it. One of the Big 4 global consultancies argued that no definition was required since, for most purposes for which a liability would need valuing, there would be definitions in place. A majority of respondents to the DP also indicated that the scope of any new standard should be a broad as possible. Although about half supported the exclusion of certain financial instruments, pension and insurance liabilities, some of these respondents indicated that there were some consistent principles that could be applied to ANY liability. The Board concluded that there was no need to restrict the application of the standard by defining a liability in a particular way, especially since "asset" was not at that time defined.[1] It did conclude that there should be some exclusions, principally derivatives, pensions and insurance liabilities. In the case of the latter two it was noted that the IAA already produced standards for their measurement. These findings were reflected in the brief for the expert working group formed to develop a draft standard approved by the Board in March 2014. In our experience the better approach to standard setting is to rely on the normal dictionary meaning of a word wherever possible. If there is a need to

[1] *While a definition of "Asset" has been introduced in IVS 2017 this just clarifies that the word is used to signify any item that may be subject to valuation, including a liability. This is another reason why attempting to introduce a new and narrow definition for liabilities covered by the standards is unhelpful in the overall context of the IVSs.*

Para in Draft	Comment
	limit the scope it is better to indicate the exclusions. This ensures that the standard has the widest application and avoids attempts to argue that the valuation of a particular type of liability is not covered by the IVS because it does not meet the precise definition provided. Other advantages of not limiting the standard to "non-financial liabilities" include: • Since all liabilities that can be valued must be measurable financially, it would avoid a source of potential confusion, especially in translation from English. • It would avoid confusion with accounting practice, where the terms financial and non-financial are sometimes used to describe certain liabilities but not necessarily in the same way as intended by this standard. This could lead to inappropriate application of the standard. • It would avoid unintentional limitation of the scope of the proposed standard and potential conflicts with liability definitions used for accounting or other purposes. • For many purposes for which a liability needs to be valued there may already be a definition in place, as indicated by paragraph 20.5 in the draft. • Brevity. We therefore recommend that a standard is produced that is applicable to all liabilities except for those specially excluded, for example bonds and other debt instruments, derivatives, deposits, insurance contracts and pensions. This would be consistent with the feedback received to the 2013 Discussion Paper.
General	**Contents:** Presumably there will be a contents list, like that for all other standards in IVS 2017?
20.1 – 20.3	**Needs simplification and concise summary of scope:** All existing standards IVS 200 – IVS 500 have a description of what the standard applies to in the first paragraph of the Introduction. This helps understanding and keeps a consistent style across the standards. In contrast, the Introduction to this draft starts with an instruction "*The valuer should determine if the subject liability is a financial or non-financial liability.*" No definition or description has been provided of what a non-financial liability is at this stage. Although we do not believe any definition of a liability is necessary, see our earlier comment, a clear statement of scope should be made right at the beginning. Neither is it clear why a valuer is told to determine whether the liability is financial or non-financial. There is no equivalent instruction in other standards. For example, the Introduction to IVS 210 discusses different types of Intangible Asset but does not instruct the valuer to determine which type it is. The standard should provide a clear statement of what it applies to and what it does not. There is no more need to make this a matter for the valuer

Para in Draft	Comment
	to determine than it is to ask the valuer to determine whether the asset is real property under IVS 400. Removing the references to financial and non-financial liabilities will help simplify and improve the clarity of the standard.
20.5	**Bases of Value:** This paragraph seems misplaced. The first sentence would be better positioned under 30. The second and third sentences are duplicated by 30.2.
30	**Bases of Value:** This section would benefit from some examination of how the bases defined in IVS 104 may be applied to liabilities. Clearly Market Value and IFRS 13 Fair Value can be applied where the measurement required is of the payment that would need to be made to transfer a liability. However, other bases and concepts in IVS 104 have less, or even no, relevance to liabilities. For some bases examples might help, for example the concept of synergistic value could apply if the overall cost of fulfilment could be reduced through economies of scale gained from combining multiple liabilities. Earlier discussions with the IAA confirmed that in their area of practice most liabilities are valued on basis of the estimated cost to the entity, ie there is no premise of an exchange or transfer. For an asset “Investment Value” is identified in 104 as a suitable entity specific basis, but respondents to the DP considered it inappropriate for liabilities, not least because an entity would rarely obtain benefit from owning a liability (tax credits excepted) and also because liabilities are not investments in the commonly accepted sense. While it is probably unnecessary to produce an IVSC definition for entity specific liability measurement, acknowledgement that such an approach may be often required would helpful in helping users of the standard understand the different approaches that are often appropriate when valuing liabilities as compared to assets and avoid the inappropriate use of bases defined in IVS 104.
40.1	**Valuation Approaches:** The first sentence is inconsistent with 70.1 which indicates that the Cost Approach has limited application. Notwithstanding this, we are aware that some argue that the cost of fulfilling a liability can be determined using the cost approach, ie using the cost of fulfilling an equivalent liability as a benchmark. Whether this is accepted as a proper interpretation of the cost approach is a matter for debate, but whatever the Board decides, its decision and an explanation should be provided in section 70.
50.3	**Market Approach:** Although this statement is true, there are exceptions and examples could be usefully provided. In the real estate market where leases can be normally be transferred by the lessee, it is not uncommon for an outgoing lessee to pay an incoming lessee for outstanding liabilities, for example outstanding

Para in Draft	Comment
	repairs or where the rental obligation until the end of the term is in excess of current market levels.
50.5 (a)	**Market or Cost:** Is not this example four square with the definition of the Cost Approach? (see comment on 40.1 above**)**
50.10	**Not the Only Acceptable Method:** Since all applications of the Market Approach involve comparison with "guideline transactions" this paragraph is superfluous and could be seen as contradicting the discussion of the "Top Down Method" that follows. Suggest it is deleted.
50.11	**Abbreviation:** It has already been explained that the abbreviation CVR is used for "contingent value rights" in 50.5 (d). Either the phrase "contingent value rights" should be deleted here, or the abbreviation deleted from the only two places it appears. The latter would be preferable if the objective is to improve readability.
50.12	**Superfluous Subheading:** "Market Approach Methods" is superfluous and should be deleted. Only one method is discussed and the current para 50.12 can easily be placed beneath the sub heading "Top Down Method".
50.15	**Fair Value:** Why is discounting typically not necessary specifically for estimating "fair value"? The same is true for any basis/definition that assumes a market based transaction.
60.4	**Profit Margin:** The statement that the costs to fulfil the obligation should be subject to a "reasonable mark-up" needs expanding to explain that this "mark-up" may be needed to reflect either the opportunity cost caused by holding the liability or the risk of the current estimate of the costs of fulfilment proving inadequate. Different approaches are needed to the calculation of each.
60.5 (a)	**Fulfilment Cost:** This is unnecessarily convoluted. The fourth sentence beginning "Fulfilment costs represent …" is unnecessary as this is already effectively explained in the first three sentences. The last sentence beginning "Costs incurred as part of the selling activities…" makes no sense in context. What selling activities? It appears this sentence may relate to a specific type of liability but is misplaced in generic discussion about calculating the fulfilment cost that needs to be applicable to a wide range of liabilities. We suggest the final two sentences should be deleted.

Para in Draft	Comment
60.5 (b)	**Mark up:** This is not well explained. We believe that a mark-up on the estimated fulfilment cost may be appropriate for the following reasons: - If an entity would fulfil the liability using resources that it would otherwise employ in profitable activity, adding an allowance for "profit" is a way of reflecting the opportunity cost of holding the liability. If the obligation can be fulfilled by a third party contractor, the opportunity cost would be limited to the resources required for management of the contractor. This is not really made clear by the final sentence which instead mentions the contractor's profit margin, which is totally irrelevant. - If the basis of value required is based on the amount required to transfer the liability, an allowance needs to be made to reflect the risk to the hypothetical transferee of the current estimated costs being inadequate to cover the obligation when it falls due. The following paragraph suggests that this is considered preferable to altering the discount rate. If this is the case, then how this might be done needs discussion, if not here then in the section dealing with cash flows.
60.5 (c)	**Discount Rates:** We note that Discount Rates are discussed in detail under Section 90 of the draft. It would make more sense to position this discussion as a subsection of 60 following on immediately after the current 60.5, as it is only applicable to applications under the Income Approach. If it is retained as a standalone section it needs to be cross referenced from 60.5 (c) as the discussion here is totally inadequate.
70	**Cost Approach:** As pointed out earlier, the statement in 70.1 is inconsistent with 40.1. This section needs some expansion. While a narrow interpretation of the Cost Approach definition can lead to the conclusion that it is not applicable to liabilities, as a hypothetical "buyer" would not consider the cost of an equivalent alternative liability, in practice many do not make this distinction. The inputs used to calculate the cost of fulfilment using an Income Approach will normally be based on observed or estimated costs. The responses to the DP indicated that many see this process as an application of the Cost Approach. While we agree that the use of the Cost Approach as defined in IVS 105 is not usually appropriate, this needs explanation to draw a distinction between the concept of obtaining an "asset"[2] of equal utility and the use of costs from fulfilling equivalent liabilities.

[2] *Which in IVS 105 includes a liability.*

Para in Draft	Comment
80	**Special Considerations:** This is a pointless section, and completely redundant if a contents list is provided at the start of the standard, as it is with all current published standards.
90	**Discount Rates** The discussion in this section is hardly helpful in flagging the specific considerations required when selecting an appropriate discount rate to value a liability. Indeed, the current discussion could be applied to the valuation of assets in its entirety, contrary to the statement in the second sentence of 90.1. At the very least it needs to flag that, in contrast to using an Income Approach to value an asset, increased risks need to be reflected by a decrease in the discount rate, unless this risk is already reflected by probability weighting the predicted costs of future fulfilment. While this may appear to be obvious, some responses to the earlier DP indicated that this is not always understood. In this respect the current 90.2 is unhelpful as it refers to a return on investment without explaining how such a return is measured in relation to a liability, and the concept of "investing" in a liability will be counter intuitive to many. Although the first sentence of 100.5 indicates that the discount rate should not be increased to reflect risk, this is preceded by a number of statements that imply the opposite. It is also in a section dealing with cash flow rather than discount rates. A clear statement of the principle needs to be made at the start of any discussion about discount rates for liabilities and potentially contradictory statements avoided. Given the discussion under the heading "Negative Discount Rates" on p26 of the preamble that accompanies the proposed standard it is surprising that this section is silent on this issue. Paragraph 100.6, which is cross referenced from p26, simply refers to the possibility of adjusting the discount rate to allow for risk as an alternative to weighting the predicted cash flows, with no indication of the principles that need to be considered, let alone whether negative rates may be needed in some cases.
100	**Cash Flows and Risk Margins:** As in the case of Section 90, this is a discussion of inputs used under the Income Approach and would be more appropriately positioned as a sub section of Section 60. Only paragraphs 100.1 to 100.3 and 100.7 to 100.9 are concerned with Cash Flows. Paragraphs 100.4 and 100.5 concern discount rates and should be moved to that section. 100.6 indicates the alternative ways in which non-performance risk can be reflected in applying an Income Approach and should be merged into the current 60.5(c)
100.4	**Discount Rates:** The statement that the discount rate is typically the risk-free rate **plus** non-performance risk is potentially misleading as it will imply to most that the

Para in Draft	Comment
	discount rate is increased above the risk free rate, which would have the effect of reducing the liability. In our experience the time cost of money is generally regarded as the maximum rate that should be used for calculating the NPV of a future liability. The rate is often reduced to reflect the risk of non-performance, ie the negative value of the liability is increased to reflect this risk. While in the writer's experience of litigation involving real estate liabilities such adjustments always resulted in an effective discount rate above zero, this dates from before the low rates of the past decade. We agree with the Board's finding on p26 that negative rates could be appropriate where the valuation date falls within the period of very low risk-free rates seen during recent years. Discussion of the issues that are particular to discount rates used for establishing the negative value of liabilities needs far more attention in this standard, while principles that are common to the valuation of assets can be excluded as these are already covered in IVS 105.
100.5	**Discount Rate Adjustment:** As previously indicated, the point that the risks associated with a liability are not reflected by increasing the discount rate needs to be made more clearly and at the start of the discussion of discount rates in this standard. The final sentence indicating that risks are typically reflected in the cashflows seems to be partially contradicted by 100.6. As suggested above, the fact that risks can be reflected by either adjusting the cash flows or the discount rate would be better placed as a single discussion under the application of the Income Approach before the sections dealing with the discount rate and cash flow discuss how this can be done in each case.

ADDITIONAL COMMENT

Litigation Liabilities:

We note that litigation reserves are listed as an example of a (non-financial) liability in 20.2, and on p16 of the preamble, there is a note that the Board "*… did not identify any disconfirming (sic) information to the conclusions reached within this Exposure Draft.*" However, although a clear majority of respondents to the DP wished litigation liabilities to be included in any future guidance issued by the IVSC, they also expressed concerns. The most common reservation was the need to clearly distinguish the value of a liability from a recommended settlement figure, as the latter could vary significantly from the value based on the tactical considerations of the parties. Other concerns involved the need to avoid inadvertent disclosure of privileged legal advice through the medium of a valuation report. There were a number of calls for such issues to be addressed in any future IVSC guidance.