3 May 2013

Our ref: ICAEW Rep 68/13

IVSC
68 Lombard Street
London EC3V 9LJ
United Kingdom
CommentLetters@ivsc.org

Dear Mr Sherman

Proposed Revisions to IVSC Discussion Paper: Valuation of Liabilities

ICAEW is pleased to respond to your request for comments on the IVSC Discussion Paper: *Valuation of Liabilities.*

ICAEW is keen to play an active role in this project, and the ICAEW Valuation Group Committee would welcome a meeting for further discussion on this matter as a whole.

Please contact me should you wish to discuss any of the points raised in the attached response.

I look forward to hearing from you.

Yours sincerely

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Head of Special Interest Groups

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ICAEW REPRESENTATION

PROPOSED REVISIONS TO IVSC DISCUSSION PAPER: VALUATION OF LIABILITIES

Memorandum of comment submitted in May 2013 by ICAEW, in response to IVSCs Discussion Paper: *Valuation of Liabilities* published in February 2013.

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INTRODUCTION

1. ICAEW welcomes the opportunity to comment on the IVSC Discussion Paper: *Valuation of Liabilities* published on 1 February 2013, a copy of which is available from this link. We have responded selectively to the questions included in the discussion paper; unanswered questions have not been reproduced below

WHO WE ARE

2. ICAEW is a world-leading professional accountancy body. We operate under a Royal Charter, working in the public interest. ICAEW's regulation of its members, in particular its responsibilities in respect of auditors, is overseen by the UK Financial Reporting Council. We provide leadership and practical support to over 140,000 member chartered accountants in more than 160 countries, working with governments, regulators and industry in order to ensure that the highest standards are maintained.

3. ICAEW members operate across a wide range of areas in business, practice and the public sector. They provide financial expertise and guidance based on the highest professional, technical and ethical standards. They are trained to provide clarity and apply rigour, and so help create long-term sustainable economic value.

4. The Valuation Group is the voice of Valuers within ICAEW, and the committee includes representatives from the business and practice communities. It draws together professionals engaged in valuation and its 850 members receive a range of services including an annual conference, quarterly newsletters, and regular seminars providing technical insight and practical guidance.

MAJOR POINTS

5. The IVSC scope is wider than just financial reporting. The proposed IVSC definition of a liability is: "An obligation which could result in an outflow of resources". This does not refer to past events and it would appear to cover both liabilities and contingent liabilities. It would be our preference for concepts such as liabilities and contingent liabilities to remain distinct within this paper. We would also prefer it if the definition closely followed that within IFRS.

As a general proposition, we are concerned that different definitions of the same term should be avoided as much as possible: the definitions within both UK GAAP and IFRS have been closely argued and honed by exposure and debate. At present the definitions of liabilities under UK GAAP and IFRS are as follows:

UK GAAP: "obligations of an entity to transfer economic benefits as a result of past transactions or events";

IFRS: "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."

There is some considerable overlap between these two definitions and their practical implementation is, with some notable exceptions (e g holiday pay, deferred taxation), relatively similar.

6. The financial reporting definition for liabilities may off course be too narrow for other purposes, and a different definition may be appropriate. It would be helpful if the IVSC explained the objective of the paper more clearly.

RESPONSES TO SELECTED SPECIFIC QUESTIONS

QUESTION 1: Do you agree that the IVSC should produce a standard or guidance on the valuation of liabilities as defined above? If not please explain why.

7. Our view is that an IVSC standard on the valuation of liabilities is not needed. There is guidance currently available in accounting standards and given the proposed standard excludes various liabilities, we are of the view that its requirements may be taken out of context to support unintended conclusions. Further, the general principles set-out in the IVS valuation standards should be sufficient to cover liabilities and assets.

The IVSC should be clear that where a valuation is for financial reporting purposes, the accounting standards take priority in any guidance. The standard needs to help improve the consistency of valuation of liabilities to have any substantial practical benefit. Any guidance therefore would need to be specific enough and provide examples that are of practical use.

QUESTION 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.

8. The proposed definition is "*An obligation which could result in an outflow of resources*."

i. We consider that this is too broad – there are many obligations which could result in an outflow of resources, but not all should be considered as liabilities. This definition includes contingent liabilities, and we consider that these two concepts should be separate.
ii. The reason for a deviation from the IFRS definition "*A liability is 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*" [FR: 49(b)] should be clearly explained.

Perhaps the IVSC should make it clear why their definition differs from the IFRS definition and what else they are trying to capture.

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

9. As previously noted, we do not think standards on liabilities will provide a net benefit to valuers. However, if a standard is to be produced, we consider that it should include financial instruments or a separate standard on financial instruments should also be produced.

We note that if the valuation of financial liabilities is to be excluded from scope, the title of the paper 'Valuation of Liabilities' should be changed as this is misleading for anyone looking for guidance in this area.

If financial liabilities are included in scope, the IVSC needs to be very clear on the differences between their guidance and IFRS guidance i.e. examples of why there might be a difference and a statement that IFRS takes priority for financial reporting purposes

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

10. If a standard is to be produced, its use will be limited if commonly observed liabilities are to be excluded from it. Therefore, if a standard is issued, it should cover all potential liabilities that a valuer may be requested to consider.

QUESTION 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.

11. As contingent consideration (e.g. earn outs in corporate finance transactions) and other contingent sums (e.g. overage income on the granting of planning consents on property sales) are common liabilities in financial reporting, we consider that it would be helpful if the guidance could embrace these liabilities. We consider that these liabilities are relatively straightforward in any event as they can be considered to be the mirror images of the related assets. It is our view that the guidance should lead to symmetrical outcomes whether valuing for the holder of the asset or the liability.

In agreement with point 10 above, contingent liabilities is an area where specific guidance may be beneficial, if a standard is to be produced. The absence of certainty is no barrier in the valuation of many assets where judgements have to be made regarding future performance or events. Some contingent business liabilities could be estimated with similar judgement and if a standard is to be produced, such guidance should be provided.

We consider these liabilities can be valued and uncertainty needs to be reflected in the assumptions made.

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

12. The elements that lead to a litigation liability can be calculated (e.g. loss of profit, the value of a business in question), however the actual potential damages also rely heavily on the legal framework and the court's decision on i) the binary result; and ii) if a judgement leads to a liability, the basis for the calculation of the award may reflect numerous uncertain factors. We believe litigation liabilities can be valued but the range of possible outcomes may be very wide and this should be clearly stated in any valuation.

QUESTION 10: Do you agreed 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.

13. We are of the opinion that definitions close to those used in the International Glossary of Business Valuation Terms should be used for fair market value, investment value (ie the value to a particular investor who is a special purchaser) and value in use.

QUESTION 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 rationale for supporting it.

14. The "risk free" rate is an important component of a discount rate and for certain liabilities, the "risk free" rate may be the appropriate discount rate. Guidance as to which liabilities to apply this rate to and how this is to be determined might be helpful.

QUESTION 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.

15. This depends on what is meant by 'profit'. Most companies seek to make a profit and therefore embedded in most transactions is a profit to the parties involved. i.e. is the value of a liability the cost for you to fulfil the obligation or what it would cost to pay someone else to fulfil the obligation. A question might then be whether the difference represents profit or includes other factors such as transfer of risk. It is important to reflect the fact that by their nature estimated cash flows can prove incorrect and a risk adjustment may be required.

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

16. If a standard or guidance is to be prepared, it should clearly explain and articulate the differences to IFRS standards/guidance, notwithstanding that the IVS may be used for different purposes.

Any work to summarise the IFRS requirements and relate them to IVSs should be undertaken in conjunction with the IASB to reduce the possibility of misinterpretation of IFRS.

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