

IVS 220: NON-FINANCIAL LIABILITIES



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Business & Intangible Assets Valuation



The logo for the International Valuation Standards Council (IVSC) is located in the top left corner. It features the letters 'IVSC' in white on a dark purple, tilted rectangular background. To the left of this background are three green chevron shapes pointing to the right. Below the purple background is a thin grey horizontal line.

IVSC

IVS 220: Non-Financial Liabilities

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Scope

For *purposes* of IVS 220 *Non-Financial Liabilities*, non-financial liabilities are defined as those liabilities requiring a non-cash performance obligation to provide goods or services.

A non-exhaustive list of liabilities that *may* in part or in full require a non-cash fulfilment and be subject to IVS 220 *Non-Financial Liabilities* includes: deferred revenue or contract liabilities, warranties, environmental liabilities, *asset* retirement obligations, certain contingent consideration obligations, loyalty programmes, power purchase agreements, certain litigation reserves and contingencies, and certain indemnifications and guarantees.

Although certain contingent consideration liabilities *may* require a non-cash performance obligation, such liabilities are not included in the scope of *IVS 220 Non-Financial Liabilities*.



General Considerations

Asset-liability symmetry typically does not exist for non-financial liabilities due to the performance obligation to provide goods and services to satisfy the liability and additional compensation for such effort. As such, non-financial liabilities will most often be valued using a liability framework.

Non-financial liabilities often do not have a recorded corresponding *asset* recognised by the counterparty (eg, environmental liability), or can only be transferred in conjunction with another *asset* (eg, an automobile and related warranty are only transferred together).

The corresponding *asset* of a non-financial liability *may* be held by numerous parties for which it is impractical to identify and reconcile the asset values.

The market for the non-financial *asset* and liability is often highly illiquid, thus resulting in asymmetric information, high bid ask spreads, and asset-liability asymmetry.



Market Approach – Top Down Method

Under the Top-Down Method, valuing non-financial liabilities is based on the premise that reliable market-based indications of pricing are available for the performance obligation.

The key steps in applying a Top-Down Method are to:

- (a) Determine the market price of the non-cash fulfilment.
- (b) Determine the *costs* already incurred and *assets* utilised by the transferor. The nature of such *costs* will differ depending on the subject non-financial liability. For example, for deferred revenue the *costs* will primarily consist of sales and marketing costs that have already been incurred in generating the non-financial liability.
- (c) Determine a reasonable profit margin on the *costs* already incurred.
- (d) Subtract *costs* incurred and profit from the market price.



Income Approach

Under the income approach, the *value* of a non-financial liability is often determined by reference to the present value of the *costs* to fulfil the obligation plus a profit margin that would be required to assume the liability.

Bottom-Up Method

Under the Bottom-Up Method, the non-financial liability is measured as the *costs* (which *may* or *may* not include certain overhead items) required to fulfil the performance obligation, plus a reasonable mark-up on those *costs*, discounted to present value.



Income Approach – Bottom Up Method

The key steps in applying a Bottom-Up Method are to:

(a) Determine the *costs* required to fulfil the performance obligation. Such *costs* will include the direct costs to fulfil the performance obligation, but *may* also include indirect costs such as charges for the use of contributory *assets*. Fulfilment costs represent those *costs* that are related to fulfilling the performance obligation that generates the non-financial liability. *Costs* incurred as part of the selling activities before the acquisition date *should* be excluded from the fulfilment effort.

1. Contributory asset charges *should* be included in the fulfilment costs when such *assets* would be required to fulfil the obligation and the related cost is not otherwise captured in the income statement.
2. In limited instances, in addition to direct and indirect costs, it *may* be appropriate to include opportunity costs. For example, in the licensing of symbolic intellectual property, the direct and indirect costs of fulfilment *may* be nominal. However, if the obligation reduces the ability to monetise the underlying *asset* (in an exclusive licensing arrangement for example), then the *valuer should* consider how *participants* would account for the potential opportunity costs associated with the non-financial liability.



Income Approach – Bottom Up Method

(b) Determine a reasonable mark-up on the fulfilment effort. In most cases it *may* be appropriate to include an assumed profit margin on certain *costs* which can be expressed as a target profit, either a lump sum or a percentage return on *cost* or *value*. An initial starting point *may* be to utilise the operating profit of the entity holding the subject non-financial liability. When *costs* are derived from actual, quoted or estimated prices by third party suppliers or contractors, these *costs* will already include a third party's desired level of profit.

(c) Determine timing of fulfilment and discount to present value.

(d) When fulfilment *costs* are derived through a percent of revenue, *valuers should* consider whether the fulfilment *costs* already implicitly include the impact of discounting. For example, prepayment for services *may* result in a discount as one would expect to pay less for the same service as compared with paying throughout the contract term. As a result, the derived costs *may* also contain an implicit discount and further discounting *may* not be necessary.



Cost Approach

The cost approach cannot normally be applied in the *valuation* of businesses and business interests as these *assets* seldom meet the criteria in IVS 105 *Valuation Approaches and Methods*, paras 70.2 or 70.3. However, the cost approach is sometimes applied in the *valuation* of businesses, particularly when:

(a) the business is an early stage or start-up business where profits and/ or cash flow cannot be reliably determined and comparisons with other businesses under the market approach is impractical or unreliable,

(b) the business is an investment or holding business, in which case the summation method is as described in IVS 105 *Valuation Approaches and Methods*, paras 70.8-70.9, and/or

(c) the business does not represent a going concern and/or the *value* of its *assets* in a liquidation *may* exceed the business' *value* as a going concern.

Replacement Cost

Generally, replacement cost is the *cost* that is relevant to determining the *price* that a *participant* would pay as it is based on replicating the utility of the *asset*, not the exact physical properties of the *asset*.

Usually replacement cost is adjusted for physical deterioration and all relevant forms of obsolescence. After such adjustments, this can be referred to as depreciated replacement cost.

The key steps in the replacement cost method are:

- (a) calculate all of the *costs* that would be incurred by a typical *participant* seeking to create or obtain an *asset* providing equivalent utility,
- (b) determine whether there is any depreciation related to physical, functional and external obsolescence associated with the subject *asset*, and
- (c) deduct total depreciation from the total *costs* to arrive at a *value* for the subject *asset*.

The replacement cost is generally that of a modern equivalent *asset*, which is one that provides similar function and equivalent utility to the *asset* being valued, but which is of a current design and constructed or made using current cost-effective materials and techniques.

Reproduction Cost Method

Reproduction cost is appropriate in circumstances such as the following:

- (a) the *cost* of a modern equivalent *asset* is greater than the *cost* of recreating a replica of the subject *asset*,
or
- (b) the utility offered by the subject *asset* could only be provided by a replica rather than a modern equivalent.

The key steps in the reproduction cost method are:

- (a) calculate all of the *costs* that would be incurred by a typical *participant* seeking to create an exact replica of the subject *asset*,
- (b) determine whether there is any depreciation related to physical, functional and external obsolescence associated with the subject *asset*, and
- (c) deduct total depreciation from the total *costs* to arrive at a *value* for the subject *asset*.



IVS 105 Cost Considerations

An *asset* acquired from a third party would presumably reflect their *costs* associated with creating the *asset* as well as some form of profit margin to provide a return on their investment.

As such, under *bases of value* that assume a hypothetical transaction, it *may* be appropriate to include an assumed profit margin on certain *costs* which can be expressed as a target profit, either a lump sum or a percentage return on *cost* or *value*.

However, financing costs, if included, *may* already reflect *participants'* required return on capital deployed, so *valuers should* be cautious when including both financing costs and profit margins.

When *costs* are derived from actual, quoted or estimated prices by third party suppliers or contractors, these *costs* will already include a third parties' desired level of profit.

Summation Method

The summation method, also referred to as the underlying *asset* method, is typically used for investment companies or other types of *assets* or entities for which *value* is primarily a factor of the *values* of their holdings.

The key steps in the summation method are:

- (a) value each of the component *assets* that are part of the subject *asset* using the appropriate valuation approaches and methods, and
- (b) add the *value* of the component *assets* together to reach the *value* of the subject *asset*.



Discount Rate for Nonfinancial liabilities

The *discount rate should* account for the time value of money and non-performance risk. Non-performance risk is typically a function of counterparty risk (ie, credit risk of the entity obligated to fulfil the liability).

Certain *bases of value* issued by entities/organisations other than the IVSC *may* require the *discount rate* to specifically account for liability specific risks. The *valuer must* understand and follow the regulation, case law, and other interpretive guidance related to those *bases of value* as of the valuation date.

Valuers should consider the term of the subject non-financial liability when determining the appropriate inputs for the time value of money and non-performance risk.

In certain circumstances, the *valuer may* explicitly adjust the cash flows for non-performance risk. What a *participant* would have to pay to borrow the funds necessary to satisfy the obligation *may* provide insights to help quantify the non-performance risk.

Given the long-term nature of certain non-financial liabilities, the *valuer must* consider if inflation has been incorporated into the estimated cash flows, and *must* ensure that the *discount rate* and cash flow estimates are prepared on a consistent basis.



Estimating Cash flows

Non-financial liability cash flow forecasts often involve the explicit modelling of multiple scenarios of possible future cash flow to derive a probability-*weighted* expected cash flow forecast. This method is often referred to as the Scenario-Based Method (SBM). The SBM also includes certain simulation techniques such as the Monte Carlo simulation. The SBM is commonly used when future payments are not contractually defined but rather vary depending upon future events.



Estimating Cash flows

Considerations in estimating cash flows include developing and incorporating explicit assumptions, to the extent possible. A non-exhaustive list of such assumptions *may* include:

- (a) The *costs* that a third party would incur in performing the tasks necessary to fulfil the obligation,
- (b) Other amounts that a third party would include in determining the *price* of the transfer, including, for example, inflation, overhead, equipment charges, profit margin, and advances in technology,
- (c) The extent to which the amount of a third party's *costs* or the timing of its *costs* would vary under different future scenarios and the relative probabilities of those scenarios, and,
- (d) The *price* that a third party would demand and could expect to receive for bearing the uncertainties and unforeseeable circumstances inherent in the obligation.



Risk Margins

In developing a risk margin, a *valuer must*:

- (a) document the method used for developing the risk margin, including support for its use, and,
- (b) provide evidence for the derivation of the risk margin, including the identification of the significant inputs and support for their derivation or source.

In developing a cash flow risk margin, a *valuer must* consider:

- (a) the life/term and/or maturity of the *asset* and the consistency of inputs,
- (b) the geographic location of the *asset* and/or the location of the markets in which it would trade,
- (c) the currency denomination of the projected cash flows, and
- (d) the type of cash flow contained in the forecast, for example, a cash flow forecast *may* represent expected cash flows (ie, probability-*weighted* scenarios), most likely cash flows, contractual cash flows, etc



Risk Margins

In developing a cash flow risk margin, a *valuer should* consider:

- (a) the less certainty there is in the anticipated fulfilment costs and fulfilment margin, the higher the risk margin *should* be,
- (b) given the finite term of most non-financial liabilities, as opposed to indefinite for many business and asset valuations, to the extent that emerging experience reduces uncertainty, risk margins *should* decrease, and vice versa,
- (c) the expected distribution of outcomes, and the potential for certain non-financial liabilities to have high 'tail risk' or severity. Non-financial liabilities with wide distributions and high severity *should* have higher risk margins,
- (d) the respective rights and preferences of the non-financial liability, and/or related *asset*, in the event of a liquidation and its relative position within the liquidation waterfall.



Restrictions on Transfer

Non-financial liabilities often have restrictions on the ability to transfer. Such restrictions can be either contractual in nature, or a function of an illiquid market for the subject non-financial liability.

When relying on market evidence, a *valuer should* consider an entity's ability to transfer such non-financial liabilities and whether adjustments to reflect the restrictions *should* be included. The *valuer may* need to determine if the transfer restrictions are characteristics of the non-financial liability or restrictions that are characteristics of an entity, as certain *basis of value may* specify one or the other be considered.

When relying on an income approach in which the non-financial liability value is estimated through a fulfilment approach, the *valuer should* determine if an investor would require an additional risk margin to account for the limitations on transfer.