

CONSULTATION ON IMPROVEMENTS TO GN8 – THE COST APPROACH FOR FINANCIAL REPORTING

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International Valuation Guidance Note 8 (GN8) was substantially revised prior to the current edition of the International Valuation Standards, published in 2005.

Although these revisions were the culmination of a significant period of consultation that commenced in 2002, because of the need to have the revised guidance in place for the beginning of 2005 when IFRS were being adopted in the EU, Australia and New Zealand, there was no time to issue an exposure draft detailing the Board's conclusions. Subsequently representations have been received requesting clarification or suggesting minor improvements. The proposed amendments have been made in the draft copy of a revised Guidance Note that follows.

Summary of Proposed Amendments

1. Definition of depreciated replacement cost

It is proposed that reference to reproduction should be removed from this definition. It is argued that allowing apparently alternative approaches to the assessment of cost potentially adds confusion and could cause inconsistency. The underlying principle of substitution referred to in 1.2 requires the valuer to consider the cost of replacing the actual asset with a modern equivalent asset, rather than a direct reproduction. Although in practice there will be occasions when the cost of replacement is the same as the cost of reproduction, the two words are not analogous.

3 References to Plant & Equipment

A request has been received that the definition of *plant and equipment* be included in section 3, as depreciated replacement cost is a method used more frequently for this class of asset than for real property.

4 Modern Equivalent Asset

A modification of this definition is proposed so as to make it equally applicable to all tangible asset classes

5 Impairment Loss

This definition is deleted as it is not used in the Guidance Note

6 Optimisation

Amendments have been made to improve this definition.

7 Application of drc

The current 5.1 states that specialised assets must be distinguished from assets that are commonly traded in the market. The reason for making this distinction in the context of this paper is not explained. The following paragraph 5.2 currently explains the test for when the drc approach should be used. It is therefore proposed that the current 5.1 be deleted.

8. **Separating guidance for assessing cost from that for assessing depreciation.**

5.4 has been separated to provide distinct guidance on assessing cost, which relates to a modern equivalent asset, and assessing depreciation, which involves comparing the actual asset with the modern equivalent.

The current 5.4.1 has caused some confusion. The changes clarify that in assessing the cost of an equivalent specialised property, it is only the cost of acquiring equivalent land that is relevant. If the actual land has potential for alternative use, this is not reflected in the cost of the hypothetical equivalent asset upon which the drc approach is based; any potential for other uses on the actual site will be determined by the sales comparison method. Unless both methods are used in cases where the land is identified as having potential, the question of which produces the higher value cannot be answered.

The words “or external” are removed from the list of depreciation types. The explanatory note in 5.4.3 (old 5.4.5) explains that economic factors are confined to external rather than entity specific influences, so this partial explanation is redundant. 5.4.3 has been amended to reinforce this point.

Because the wording has been revised so that it is applicable to property plant and equipment, and the process of establishing the cost of the equivalent asset separated from depreciation adjustments, it is necessary to add 5.4.4 clarifying that land is not normally depreciated.

The current 5.7 is deleted as this point is now covered the revision to 5.4.

9 **Reordering of current paragraphs**

The current 5.9 lists matters a Valuer needs to consider in assessing depreciation. This has been brought forward to follow the discussion on depreciation types. The current 5.8 now follows this list as a new 5.6 to reinforce the objective of the drc approach.

10 **Need to “Stand back and look”**

A potential flaw in the application of drc is that there can be an overly theoretical approach to the identification and assessment of depreciation. Although mathematical analysis has an important role, it will not necessarily give an answer that reflects the underlying objective of a market transaction. A new paragraph 5.7 has been included to emphasise the need to reconcile the figure calculated with the objective of establishing the price that would be paid between market participants for the actual asset.

10 **Value for land alternative use**

The situation described in the old 5.5 was specific to *specialised property*. This is made clear in the proposed replacement, which is renumbered 5.8. The current wording also appears to require the valuer to establish what alternative uses may be available on the land in every case. This could involve speculation by the valuer and also incur the instructing entity in unwarranted additional cost. A request has been made that this paragraph be modified so that the requirement to report Market Value only arises where an alternative use for the site can be readily identified, is commercially and legally feasible, and has a materially higher value. In other cases a simple statement that the value of the site for an alternative use may be significantly higher than the reported valuation will be sufficient. The wording has been revised to reflect this.

A new 5.7 has been added to deal with situations where the criteria in 5.8 for undertaking a valuation of the land based on an alternative use are not met, but where the valuer can identify that the prospect of possible future development would enhance the value based on simple comparison with a modern equivalent asset.

11 Applicability to Plant & Equipment

Other minor changes have been made to clarify the applicability of this guidance to plant and equipment as well as real property.

International Valuation Guidance Note No. 8

The Cost Approach for Financial Reporting-(DRC)

Proposed revisions 2006

1.0 Introduction

- 1.1 The purpose of this Guidance Note (GN) is to assist users and preparers of Valuation Reports in the interpretation of the meaning and application of *depreciated replacement cost* for financial reporting purposes.
- 1.2 *Depreciated replacement cost* is an application of the cost approach used in assessing the value of specialised assets for financial reporting purposes, where direct market evidence is limited. As an application of the cost approach, it is based on the principle of substitution.

2.0 Scope

- 2.1 This GN provides background to the use of *depreciated replacement cost* in connection with International Valuation Application 1 (IVA 1), Valuation for Financial Reporting.
- 2.2 The *depreciated replacement cost* approach is also discussed in GN3 (Valuation of Plant and Equipment) and IVA 3 (Valuation of Public Sector Assets for Financial Reporting, publication forthcoming).

3.0 Definitions

- 3.1 *Depreciated Replacement Cost.* The current cost of replacing an asset with a modern equivalent asset less deductions for physical deterioration and all relevant forms of obsolescence and optimisation.
- 3.2 *Plant and Equipment.* Tangible assets, other than *realty*, that:
- (a) are held by an entity for use in the production or supply of goods or services, for rental by others, or for administrative purposes; and
 - (b) are expected to be used over a period of time

The categories of plant and equipment are:

Plant. Assets that are inextricably combined with others and that may include specialised buildings, machinery, and equipment.

Machinery. Individual machines or a collection of machines. A machine is an apparatus used for a specific process in connection with the operation of the entity.

Equipment. Other assets that are used to assist the operation of the enterprise or entity.

- 3.3 *Specialised Property.* *Real property* that is rarely, if ever, sold in the market, except by way of a sale of the business or entity of which it is part, due to uniqueness arising from its specialised nature and design, its configuration, size, location, or otherwise.

- 3.4 *Improvements*. Buildings, structures, or some modifications to land, of a permanent nature, involving expenditures of labour and capital, and intended to enhance the value or utility of the property. Improvements may have differing patterns of use and economic lives.
- 3.5 *Adequate Profitability*. When an asset has been valued by reference to *depreciated replacement cost*, *adequate profitability* is the test that the entity should apply to ensure that it is able to support the *depreciated replacement cost* conclusion.
- 3.6 *Service Potential*. The capacity of an asset to continue to provide goods and services in accordance with the entity's objectives.
- 3.7 *Modern Equivalent Asset*. An asset which has a similar function and equivalent productive capacity to the asset being valued, but of a current design and constructed or made using current materials and techniques,...
- 3.8 *Optimisation*. The process by which a least cost replacement option is determined for the remaining service potential of an asset. It is a process of adjusting the replacement cost to reflect that an asset may be technically obsolete or over-engineered, or the asset may have a greater capacity than that required. Hence optimisation minimises, rather than maximises, a resulting valuation where alternative lower cost replacement options are available.

4.0 Relationship to Accounting Standards

- 4.1 *Depreciated replacement cost* is used where there is insufficient market data to arrive at Market Value by means of market-based evidence.
 - 4.1.1 International Accounting Standard (IAS) 16, Property, Plant and Equipment, paragraph 33, provides that in the absence of market-based evidence an entity may need to estimate the fair value of a specialised asset using an income or a depreciated replacement cost approach.
 - 4.1.2 International Public Sector Accounting Standard (IPSAS) 17, Property, Plant and Equipment, paragraphs 42 and 43, prescribe the use of *depreciated replacement cost* for valuing *specialised buildings and other man-made structures* as well as *items of plant and equipment of a specialised nature*.

5.0 Guidance

- 5.1 The classification of an asset as specialised should not automatically lead to the conclusion that a *depreciated replacement cost* valuation must be adopted. **Even though an asset may be specialised, it may be possible in some cases to undertake a valuation of a specialised property using the sales comparison approach and/or the income capitalisation approach.**
- 5.2 **In the absence of direct market evidence, *depreciated replacement cost* is regarded as an acceptable method of assessing the value of specialised assets but the methodology must incorporate market observations by the Valuer with regard to current costs and depreciation rates.** The methodology is based on the same theoretical transaction between rational informed parties as the Market Value concept.

- 5.3 **The Valuer assesses the cost of a *modern equivalent asset* at the relevant valuation date.** This may involve assessing the cost of having a suitable asset commissioned to order. The replacement cost needs to reflect all incidental costs that would be incurred, for example for design, delivery, installation and commissioning. In the case of *Specialised Property*, the cost of acquiring land suitable for the development of an equivalent specialised facility in the market should be included, together with the cost of all *Improvements* that would be required to the land.
- 5.4 **The Valuer then assesses depreciation by comparing the *modern equivalent asset* with the asset being valued.** Depreciation rates may be all-encompassing or analysed separately for:
- **Physical deterioration**
 - **Functional obsolescence**
 - **Economic obsolescence**
- 5.4.1 **In assessing the physical deterioration of the actual asset resulting from wear and tear over time, including any lack of maintenance, different valuation methods may be used for estimating the amount required to rectify the physical condition of the improvements.** Estimates of specific elements of depreciation and contractors' charges can be used or direct unit value comparisons between properties in similar condition.
- 5.4.2 **Functional obsolescence can be caused by advances in technology that result in new assets being capable of a more efficient delivery of goods and services.** Modern production methods may render previously existing assets fully or partially obsolete in terms of current cost equivalency. The application of the optimisation process will account for many elements of functional obsolescence.
- 5.4.3 **Economic obsolescence resulting from external influences may affect the value of the asset.** External factors include changed economic conditions, which affect the demand for goods and services produced by the asset or the costs of its operation.
- 5.4.4 **When valuing *specialised property* it is not appropriate to depreciate the cost of replacing the land element.**
- 5.5 **In the application of depreciated replacement cost, the Valuer shall ensure that the key elements of a market transaction have been considered. These include:**
- 5.5.1 **an understanding of the asset, its function, and its environment;**
 - 5.5.2 **research and analysis to determine the remaining physical life (to estimate physical deterioration) and economic life of the asset;**
 - 5.5.3 **knowledge of the business requirements (to estimate functional/technical obsolescence);**
 - 5.5.4 **an assessment of future industry requirements (to estimate economic/external obsolescence);**
 - 5.5.5 **familiarity with the class of property through access to available market data;**

- 5.5.6 **knowledge of construction techniques and materials (to estimate the cost of a *modern equivalent asset*); and**
- 5.5.7 **sufficient knowledge to determine the impact of economic/external obsolescence on the value of the improvements.**
- 5.6 **Depreciation rates and estimates of future economic life are influenced by market trends or the entity's intentions.** Valuers must identify these trends and be capable of using them to support the depreciation rates applied. The application of depreciated replacement cost should replicate the deductive process of a potential buyer with a limited market for reference.
- 5.7 In the final stage of the process Valuers should consider if the actual asset has any additional features not reflected in the cost of the *modern equivalent asset* and make any appropriate further adjustments. An example would be a *specialised property* where there is the possibility of a more valuable use in future when the *improvements* have reached the end of their economic life.
- 5.8 **If it is clear that the result based on the depreciated replacement cost method is materially lower than a readily identifiable alternative use that is both commercially and legally feasible at the date of valuation, the *Market Value* based on that alternative use shall be reported. This must include a statement that the value for the alternative use takes no account of matters such as business closure or disruption and any associated costs that would be incurred.**
- 5.9 **If the Valuer considers that the value of the asset would be materially different if it ceases to be part of the going concern, a statement to this effect should be included in the report.**
- 5.10 **A valuation of a specialised asset assessed by the *depreciated replacement cost* method is subject to the test of adequate profitability in relation to the whole of the assets held by a for-profit entity or the cash generating unit.**
- 5.11 **For not-for-profit public sector entities, the test of adequate profitability is replaced by the test of adequate *service potential*, which should be justifiable by the entity.** Governments place particular emphasis on the test of adequate service potential in asset reporting as many agencies utilise public sector assets in the context of a service obligation to the general public.
- 5.12 **The valuation conclusion shall be reported in accordance with IVS 3, Valuation Reporting.**
 - 5.12.1 **The Valuer reports the result as Market Value subject to the test of adequate profitability or justified service potential, a test which is the responsibility of the entity.**
 - 5.12.2 **In reporting the value the Valuer shall identify the valuation method as depreciated replacement cost noting that the value can only be adopted in the accounts of the entity if the relevant test of either adequate profitability or service potential is applied and met.**

6.0 Effective Date

- 6.1 This International Valuation Guidance Note became effective xxx 2007 but earlier adoption is encouraged. .