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Submitted to: CommentLetters@ivsc.org

Dear Mr Rérolle

**Depreciated Replacement Cost**

The Financial Reporting Standards Board (FRSB) of the New Zealand Institute of Chartered Accountants is pleased to submit its comments on the IVPB’s Exposure Draft Proposed Technical Information Paper 2 (ED TIP 2).

Consistent with our previous comments to the International Valuation Standards Board, we urge the Board to ensure that valuation standards and Technical Information Papers promote consistency in the measurement of assets and liabilities for IFRS financial reporting purposes.

Guidance on depreciated replacement cost is extremely important in the New Zealand context. It is widely used for the valuation of assets in both the private and public sector. In particular it is frequently used in the valuation of infrastructure assets, which represent a significant proportion of assets in the financial statements of such entities. Given the widespread use of depreciated replacement cost and its impact on financial statements, we consider that clear enunciation of the principles and consistent application of those principles by valuers is essential.

We strongly support the inclusion of guidance on the extent to which interest should be included in a valuation using the depreciated replacement cost approach and hope that the inclusion of such guidance will reduce the current diversity in practice regarding the capitalisation of interest. We also support the clarification of the nature and extent of optimisation that is appropriate.

Our key focus is to ensure that valuation standards and guidance are compatible with the relevant IFRSs, particularly the extent to which TIP 2 will be consistent, or otherwise, with the cost approach to measuring fair value in the forthcoming IFRS 13 *Fair Value Measurement* and encourage you to work with the International Accounting Standards Board to this end. We consider that TIP 2 should outline how it assists valuers in meeting the requirements of the forthcoming IFRS 13.
If you have any questions regarding this letter, please contact Joanne Scott (at +64 3 5456746 joanne.scott@nzica.com).

Yours sincerely

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Appendix

1. It is proposed that this Exposure Draft will replace the current GN8 "The Cost Approach for Financial Reporting – (DRC)". As the name suggests GN8 only covers the use of the cost approach for financial reporting purposes. This exposure draft proposes that a properly applied cost approach can be applied in a wide variety of circumstances.

Do you agree with the argument that the cost approach, if properly applied, can be used as a method to arrive at market value for a variety of purposes other than financial reporting?

We have not responded in detail to this question as our key interest is the determination of fair values for financial reporting. As noted in our cover letter we consider that TIP 2 should explicitly state that it can be used in applying the cost method in the forthcoming IFRS 13. Where any guidance in TIP 2 is inconsistent with the forthcoming IFRS 13 we consider that it should be clearly highlighted.

2. This Exposure Draft identifies depreciated replacement cost as the most common method of valuation under the Cost Approach. An alternative view is that this is the only method of applying the cost approach.

Which of these views do you support? If you believe that there are other valuation methods that fall under the Cost Approach, please describe them.

We support the view that depreciated replacement cost is the most common method of valuation under the cost approach. We note that in developing guidance on fair value measurement the IASB has not identified any particular technique as being the only means of measuring fair value using the cost approach.

The ED defines reproduction cost as a separate term but discusses the circumstances in which use of reproduction cost would be appropriate. Although we do not disagree with the examples given in paragraph 13 of the ED, we consider that the ED could be clearer about whether reproduction cost is seen as a form of replacement cost (within the cost approach) or as a different measurement basis.

3. GN8 in the 2007 edition of IVS identifies the three main types of deduction for obsolescence as physical deterioration, functional obsolescence and external obsolescence. In this Exposure Draft external obsolescence has been replaced with economic obsolescence. Supporters of the proposed change argue that the term economic obsolescence is most commonly used to describe this form of obsolescence. Those who support the existing definition argue that the term external obsolescence more clearly requires all factors that arise from changes to the environment in which the asset operates to be considered, regardless of whether they have a direct economic impact.

Which of these views do you support?

We support the use of the term economic obsolescence as it is described in the Exposure Draft. Paragraph 36 of the Exposure Draft defines this broadly as “the loss in value caused by factors which are external to the asset itself”. Given recent world events we have considered whether the description of economic obsolescence in the Exposure Draft is sufficiently broad to cover types of obsolescence arising from natural disasters. We note that, in addition to physical deterioration, natural disasters may lead to a reduced demand for a good or service or prevent access to assets. We consider that the discussion of economic obsolescence Exposure Draft is sufficiently broad to deal with these types of obsolescence.
4 The Exposure Draft provides that where the purpose of the valuation is governed by regulations that preclude adjustment for all forms of obsolescence, for example valuations for tariff setting purposes of regulated monopoly assets, the outcome does not represent market value and should not be described as such.

Do you agree that a cost approach valuation that does not identify and quantify all forms of obsolescence is not a measure of market value?

We agree with the position in the Exposure Draft.

Other comments

Although the Exposure Draft includes guidance on componentisation, we consider that it would be helpful to provide more guidance on the impact of componentisation on assessing the cost of acquiring an equivalent alternative facility. Under a broad approach to componentisation a valuer may evaluate replacement of all the assets relating to an activity. This may allow a wider range of replacement options to be considered than under a narrow approach. We recommend that TIP 2 clarify that the extent of (hypothetical) reconfiguration is limited to resources providing the same or similar goods and services as those being generated by the existing asset. We consider that the level of componentisation adopted is related to the issue of whether to adopt a Greenfields or Brownfields approach. A low level of componentisation could lead to a Brownfield’s approach as the extent of reconfiguration is likely to be more limited.

We would also like to draw your attention to an apparent inconsistency with IFRSs. The introduction to the illustrative examples (page 15 of the Exposure Draft) states that “To the extent economic obsolescence is identified it is likely that the value of any identifiable intangible assets would have already been impaired….”. If an entity is applying IAS 36 Impairment of Assets it would recognise impairment losses for a cash-generating unit in accordance with paragraph 104 of that Standard (first to any goodwill and then pro rata to other assets of the unit).