Dear Sir/Madam,

Comments on Exposure Draft – Proposed Technical Information Paper 2: Depreciated replacement cost

Thank you for the opportunity for the Institute of Chartered Accountants in Australia (The Institute) to provide comments on the IVSC exposure draft – Proposed Technical Information Paper 2: Depreciated Replacement Cost (the ED).

Overall, the Institute supports the evolution of guidance in the area of valuation practice. We consider the exposure draft paper 2 to be a sound exposition of technical matters in the contexts of depreciated replacement costs valuation. We encourage the IVSC to incorporate into the final TIP some linkage to the newly issued IFRS 13 Fair Value Measurement.

Detailed comments on the ED are set out in the Appendix of this letter. They were prepared by the Institute’s Business Valuations Special Interest Group (BVSIG). The Special Interest Group and its members are most affected by the exposure draft.

The Institute is the professional body representing chartered accountants in Australia. Our reach extends to more than 66,000 of today’s and tomorrow’s business users, with some 54,000 chartered accountants and 12,000 Australian best accounting graduates, who are currently involved in our world class graduate program.

Our members are involved in diverse roles across industry, academia, government and public practice throughout Australia and in over 109 countries around the world. The Institute is a founding member of the Global Accounting Alliance, (GAA).

In 2005, the Institute established the BVSIG, for the benefit of the Institute members and stakeholders, including regulators and the community. BVSIG has approximately 1000 members working in the field of business valuation. BVSIG is represented in most states and nationally.

Should you have any questions in relation to the matters discussed in the attached document, please contact Richard Stewart, Chair BVSIG on +61 2 8266 8839, or at richard.j.stewart@au.pwc.com.

Yours sincerely,

Lee White
Executive General Manager - Members
Institute of Chartered Accountants in Australia
Appendix

Overall observations

The exposure draft summarises well current practice in the area of depreciated replacement cost (DRC) valuation.

As a general comment, we consider that this technical information paper is of high quality and will be of considerable use to not only preparers of plant and equipment valuations, but also those who use this methodology to value intangible assets.

We include our detailed comments below:

Response to questions

1. 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 seen the DRC approach used in a variety of circumstances beyond purely financial reporting scenarios. These circumstances include tax valuations, commercial negotiations (particularly where businesses are in start-up mode and the estimation of future cash-flows is highly uncertain), and for regulatory purposes.

Accordingly, we concur that it is appropriate to generalise in this technical information paper, from the DRC approach for financial reporting to merely the DRC approach. However, in order to prevent any confusion we consider that the TIP should ensure that any differences between the newly issued IFRS 13 Fair Value Measurement are fully identified.

2. Which of these views do you support, if you believe that there are other valuations methods that fall under the cost approach, please describe them.

We concur that depreciated replacement cost is the most common method of valuation under the cost approach.

Having said that, there are significant variations that are often seen in practice including:

- Methods by which replacement cost is estimated including inflation of historic cost
- The approach to the optimization of the asset base
- The application of depreciation, including the variations described in the ED, but also commonly the actuarial-like approach developed at the University of Iowa in the 1930s
- The application of allowances for economic obsolescence, including particularly, the consideration of overall enterprise values of the organization containing the specialized assets.

However, even though the DRC methodology is the most common method, we are not of the view that this is the only method of performing cost based valuations. For example, we have seen the cost avoided as a key input to, inter alia, brand valuations. Nominating DRC as the only method of cost based valuations removes an important judgment consideration from a valuer’s armoury. Accordingly, we would strongly recommend that this is not advocated by the IVSC. Instead, an approach which advocates a reasoned judgment as to the method selected to perform the cost based valuation, would be our preferred approach.
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3. Which of these views do you support?

We support the view that economic obsolescence is sufficiently broadly drawn to encompass all forms of obsolescence.

We consider that external obsolescence is a subset of economic obsolescence, rather than the reverse as implied in this question’s preamble.

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

We concur with this statement. However, we note that in many cases, particularly for financial reporting purposes, the question of economic obsolescence is not conducted by the valuer preparing the DRC valuation. Accordingly, these estimates of value, should not be described as market value and should be limited by the absence of a comparison to the economic value estimated using other methods (such as a comparison to enterprise value as noted in Q2 above).

In relation to valuations for tariff setting for regulated monopoly assets, again, preparing a DRC valuation in accordance with regulatory guidelines should not be described as general purpose market valuation. Rather it might be more properly described as a valuation in accordance with the specified regulatory guidance.

Other matters

A difference has been identified between the TIP and accounting standard IAS 36 Impairment of Assets, in regards to the allocation of economic obsolescence, which should be rectified prior to the TIP being issued.

The illustrative examples of economic obsolescence in the third paragraph on page 15 of ED TIP2 proposes that economic obsolescence should normally be allocated to intangible assets before tangible assets. However IAS 36 allocates impairment losses for a cash generating unit firstly to any goodwill and then to all other assets on a pro rata basis.