Ladies and Gentlemen,

This letter of comment is submitted on behalf of the IFRS Committee of the International Association of Consultants, Valuators and Analysts (IACVA). We are a member of your organization and also of the World Association of Valuation Organizations (WAVO). We are a knowledge transfer and credentialing organization with Charters, issued or pending, covering Canada, China, Egypt, Germany, Ghana, India, Indonesia, Jordan, Kenya, Kuwait, Lebanon, Mexico, Nigeria, Philippines, Russia/CIS, Saudi Arabia, South Korea, Taiwan, Thailand, United Arab Emirates, United States (National Association of Certified Valuation Analysts – NACVA and the Institute of Business Appraisers – IBA) and Vietnam. The organization has nearly 10,000 members, who are mainly involved in business valuation and fraud deterrence.

As a worldwide organization, our members are extremely concerned with the development of the valuation profession. We therefore, appreciate the opportunity to comment on the Exposure Draft “Proposed Technical Information Paper 2 – Depreciated Replacement Cost”. In general, we have problems with the documents.

Answers to Questions

Our detailed observations to the questions for respondents in the ED are as follows:

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?

In general, we consider that the Cost Approach can be useful in measuring fair values for financial reporting as well as fair market or market values for tax or litigation purposes. However, we believe that the Cost Approach is most acceptable for (a) special purpose physical or intangible assets, (b) confirming conclusion from other
approaches (income or market) or (c) allocating fair, fair market or market values to individual items that, due to application of the doctrine of highest and best use, have been valued under the “in combination” premise.

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.

To our members, the term Cost Approach is used for valuing individual assets while the phrase Asset Approach is applied to business interest, such as reporting or cash generating units. However, they both are part of the Cost Approach as described in Accounting Standards Codification (ASC) 850 and International Financial Reporting Standard (IFRS) 13 both relating to Fair Value Measurement.

This response deals with both segments, which arrive at the fair, fair market or market value of an asset or business interest based on the expenditures required to create, duplicate, or replace it. In this context, creation stands for designing, fabricating and installing. Duplication means the amounts necessary to generate an identical asset. Replacement covers the design, fabrication and installation of a substitute asset that has similar capabilities or comparable utility, taking advantage of the latest technologies.

The general principle is that the fair, fair market or market value of an asset does not exceed the cost, adjusted for time-to-use, to obtain a substitute with similar characteristics. In other words, adjusted replacement cost is the highest amount a buyer would pay. This applies whether the item is developed internally or purchased.

Therefore the Cost Approach includes:

a) Replacement Cost New adjusted for certain factors (“ARC”). This represents a new unit with the most recent materials and techniques that offers the same functionality and utility as the original had at its inception, or if customized, now. Functionality is an engineering term and relates to an item’s capability to serve its intended purpose effectively. Utility is used in the economic sense of satisfying a need or operation efficiently.

The relevant factors are:

I. Functional Deterioration: The loss in value resulting from a relative inability of the asset to fulfill its intended purpose. For a telephone system, new features might be necessary to increase efficiency, therefore its ability to satisfy users’ requirements is lessened, even though the installation remains in first class operating condition.

II. Technological Obsolescence: Occurs when a new process is introduced that significantly lowers operating expenses or improves quality. For example, printing presses were often useful for more than half a century but new presses using direct digital inputs made them obsolete by omitting part of the pre-production stage.
III. **Physical Decline:** Reflects the fact that older equipment, even when well maintained and retaining full functionality is worth less than a new unit as it is likely to have negative operating costs due to spare parts and trained technicians being difficult and expensive to obtain. An example is the DC 3 aircraft, (also known as the Dakota) which about 76 years after it was introduced, is still flying in some parts of the world only because sufficient numbers were built to allow cannibalization.

IV. **Economic Deprivation:** A partial catchall that could be caused by a major drop-off in a market. For instance, in spite of temporary fashion blips and seasonal upsurges, demand for women’s and men’s hats virtually disappeared during the 1960s. However, assets previously used to make them drastically dropped in value.

Our organization, IACVA, steadfastly advises our members to avoid confusing terminology in Valuation Reports, when applying the Cost Approach. This can easily occur if any of the four factors are described using either of the common accounting terms depreciation (allocating the costs of physical assets over their useful lives and scrap value) or amortization (a similar allocation for intangible assets).

In establishing amounts for physical assets other than real property, for example plant, equipment or inventories, it is necessary to differentiate between assets that are “generally available” and those that are "custom-built". For generally available items, replacement cost is the price in the second-hand market of physically and functionally similar used equipment, or machinery of comparable capacity and utility. It also includes set-up costs and installed computer software. Where a specific unit is too outdated for any comparison, the replacement cost of a similar but newer product may be used, less a provision for condition, age and obsolescence.

Custom-built assets, specifically designed for one particular purpose have limited alternative applications; for them replacement cost is understood to be the total of the estimated expenditures necessary to reproduce and put into position, reasonably similar equipment, giving consideration to condition, age, production capacity and obsolescence.

b) **Duplication Cost New** (referred to in the ED as Reproduction) adjusted for the same four deductions (“ADC”). This related to unique assets as those with a special purpose where the original design represents part of the value; an example would be The Tower of London.

c) **Trended Cost New** with the same [(i) to (iv)] adjustments (“ATC”). This uses the original costs for an asset and bringing them up to the present through the application of indices to reflect the current levels of materials, labour and other relevant items involved. It is normally only applied to very recent created items and may be considered a substitute for the ADC method.

d) **Market Adjusted Replacement Cost** (“MRC”) In applying the Cost Approach to estimate fair values, which is an exit price ignoring the position of a willing seller, a valuator has to consider the views of market participants who might apply different amounts of adjustments than those believed appropriate by management or taxation authorities for fair market or market values.
e) For entities, the cost approach is usually applied as follows:

I. **Adjusted Shareholders’ Equity** - all financial, physical and intangible assets, as well as liabilities are adjusted to their adjusted replacement costs including a going concern component related to the assembled workforce. The total of such assets, less liabilities and any related income taxes determines the fair, fair market or market value as the case may be.

II. **Net Worth/Goodwill Value** - the Adjusted Shareholders’ Equity plus an estimate of the effective goodwill based upon the application of suitable rates of return on the financial, physical and intangible items.

III. **Liquidation Value** - this is a measure of fair, fair market or market value only in extraordinary circumstances. It is the total amount expected to be realized if the business was terminated, the assets sold in an orderly fashion and the creditors paid off as part of its winding-up, less the costs of liquidation such as legal, accounting, brokerage and auction fees.

Some physical assets, especially land and buildings, that have been owned for a significant period, may well have an ARC that differs considerably from its depreciated tax value. Not only must such assets be restated but adjustments should also be made for any tax liabilities that might arise relating to recaptured depreciation or capital gains.

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?**

Our members’ experience is that there are four factors that have to be deducted with in applying the Cost Approach. Those have been set out in our answer to Question 2. Therefore, we support neither view but believe the International Valuation Standards Board should reconsider its terminologies and adopt our factors, which apply to all types of assets rather than the three listed in GN8 that are oriented to real property.

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?**

Any valuation conclusion that does not either directly (cost approach) or indirectly (market or income approach) take into account as deductions, the four factors discussed...
in our answer to Question 2, can satisfy the requirements to be a fair value, fair market value or market value.

Definitions

The Cost Approach can be applied to any of the generally accepted types of value other than “Value-In-Use” needed for impairment testing under IFRS. The following are the definitions used by IACVA.

Fair Value

“The price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date”.

It is important to note that this definition introduced in 2006, the key factor of market participants to replace the notions of willing buyer and willing seller in fair market and market values. This is intended to ensure that its measurements are market-based exit prices, rather than entity-specific amounts, which fair market value or market value often may be.

Fair Market Value

Fair market value, a tax construct, where the adjective "fair" relates to the noun "market", rather than to "value", is defined in the US as:

"The price at which the property would change hands between a willing buyer and a willing seller when the former is not under any compulsion to buy and the latter is not under any compulsion to sell, both parties having reasonable knowledge of relevant facts, are able, as well as willing, to trade and are well-informed about the property and the market for such property."

In Canada the word “highest” is inserted before the term “price” in the first line.

Market Value

The wording for market value from the International Valuation Standards is very similar:

“The estimated amount for which a property should exchange on the date of valuation between a willing buy and a willing seller in an arms-length transaction after proper marketing wherein the parties had each acted knowledgably, prudently and without compulsion.”

In each case the resulting number is a middle, or entry, not an exit, price. All these versions of value equal economic truth plus measurement errors as well as management biases.
Legal Fair Value

Just to confuse things, a number of jurisdictions, mainly in the United States, use the term fair value in statutes relating to divorce or shareholder disputes. While specific interpretations differ by area, its ancestry dates back to the early nineteenth century. According to the Principles of Corporate Governance from the American Law Institute, legal fair value is defined as:

“the value of the eligible holder’s proportionate interest in the corporation, without any discount for minority status or ... lack or marketability ... using customary valuation concepts and techniques.”

On the other hand, fair, fair market and market values all allow appropriate premiums or discounts both for degree, or absence, of control (DAOC), as well as lack of marketability (DLOM).

Liquidation Value

Under certain circumstances, such as the failure of a business or establishing the collateral for a loan, a liquidation value may be needed. This differs from fair, fair market or market values because it normally occurs where there is a compulsion to sell. In liquidation, assets are generally disposed of on a piecemeal basis, not as a going concern.

There are two kinds of liquidation, orderly and forced. An orderly liquidation assumes the assets will be sold over a period long enough to permit normal exposure in an appropriate secondary market; in US bankruptcies, up to 18 months have been allowed in establishing orderly liquidation values. Forced liquidation is based on a lower level of exposure over a shorter period and is sometimes referred to as "auction value".

Orderly liquidation value has not been judicially defined, but for assets the traditional view may be paraphrased as:

“The most likely price, expressed in terms of money, realizable in a market in which similar property is regularly sold to willing buyers. The seller is compelled to sell, but in an orderly and advertised manner over a reasonable period on an 'as is, where is' basis, with the buyer being responsible for removal costs.”

This definition should be considered when accounting for discontinued operations or assets that are to be disposed of. In such an event, the expenses connected to the sale, including marketing and disposal costs, should be deducted.

For an entity, the comparable definition would be:

“The net amount expected to be realized if the business is terminated, the assets sold on an orderly basis and the creditors paid off as part of the closing. The net amount is after expenses connected with liquidation such as legal, accounting and certain holding and disposal costs.”
It is used by many financial analysts to establish price targets for stocks they consider under- or, less frequently, over-valued.

**Investment Value**

The investment value of an asset is

“the value to a particular owner based on individual requirements and expectations”.

It is subjective, and as such, differs in nature from most other concepts of value that are objective, impersonal and detached. It is the maximum amount a particular prospective owner would pay, particularly for physical or intangible assets related to those already owned.

**Terminology**

The ED’s terminology is likely to cause confusion to individuals whose principal language is not English. We recommend that, for example, “Obsolescence” be limited to either an overall concept or a particular effect but not both. Our views on the use of accounting terms were set out in answer to Question 2. Again, as reproduction cost can cause confusion with replacement cost, so we recommend duplication, which is universal.

**Interest During Construction**

In our view, how an asset is, or might be, financial has no bearing on its fair, fair market or market value. Therefore, interest that might be incurred during construction is not part of either the Replacement or Duplication Cost New.

**Headings**

The insertion of subheadings and a sectional paragraph numbering system would improve comprehension to non-native English speakers.

For example:

4. Replacement Costs
   4.1. Paragraph 11
   4.2. Paragraph 12
   4.3. Paragraph 13
   4.4. Historic Costs
      4.4.1. paragraph 14
      4.4.2. paragraph 15
   4.5. Components of Replacement Costs
      4.5.1. Paragraph 16 (1st part)
      4.5.2. Paragraph 16 (2nd part)
Illustrative Examples

There should be illustrative examples of at least:

(a) The development of representative ARC for a physical asset such as a building.

(b) The same procedure for an intangible assets, such as an internally used software program.

(c) The application of each of the four factors, so that a reader understands the principles involved.

The document should not be a cook book but rather, a gourmet guide.

The dollar, in one of many manifestations, is the currency of over 20 countries including: Australia, Canada, Eastern Caribbean, Ecuador, Hong Kong, New Zealand, Singapore, Suriname, Taiwan and the United States. Therefore, we recommend using the $ sign rather than CU (currency unit) in numeric Illustrative Examples.

Should a Board or staff member wish to discuss this matter further or obtain assistance in creating suitable Illustrative Examples, you may contact me during normal business hours (Eastern Time) at 416-865-9766 or by email to jimc@iacva.org.

Respectfully submitted on behalf of the IFRS Committee of IACVA
Per

James P. Catty, MA, CA•CBV, CPA/ABV, CVA, CFA, CFE
Chair