Dear Mr Rérolle

EXPOSURE DRAFT TECHNICAL INFORMATION PAPER 2 – DEPRECIATED REPLACEMENT COST

The Australian Heads of Treasuries Accounting and Reporting Advisory Committee (HoTARAC) welcomes the opportunity to provide comments to the International Valuation Professional Board (IVPB) Exposure Draft Technical Information Paper 2: Depreciated Replacement Cost.

HoTARAC is an intergovernmental committee that advises Australian Heads of Treasuries on accounting and reporting issues. The Committee is comprised of the senior accounting policy representatives from all Australian States, Territories and the Australian Government.

International Valuation Standards are adopted as national standards in Australia.

HoTARAC is providing comments in its capacity as a preparer of financial statements, rather than as a valuer.

HoTARAC strongly supports the development by the IVPB of guidance regarding the application of Depreciated Replacement Cost (DRC). This project potentially provides useful information to valuers and accountants alike.

HoTARAC accepts that valuations are undertaken for many purposes, and that financial reporting is just one of those purposes. However, HoTARAC is concerned that, developing generic guidance applicable for differing purposes, could potentially lead to ‘rules’ rather than guidance and give rise to greater potential for confusion and inconsistencies.

In this regard, HoTARAC strongly encourages the IVPB to cross reference any valuation guidance to the Accounting Standard requirements, where relevant. Additionally, HoTARAC continues to encourage the valuation profession to work in close consultation with the International Accounting Standards Board, on matters impacting on financial reporting.

Further detailed comments are attached. If you have any queries regarding HoTARAC’s comments, please contact Robert Williams from New South Wales Treasury on 612 9228 3019.

Yours sincerely

[Signature]

Grant Hehir
CHAIR
HEADS OF TREASURIES ACCOUNTING AND REPORTING ADVISORY COMMITTEE

30 May 2011
**HoTARAC Response to IVPB ED Proposed Technical Information Paper 2 Depreciated Replacement Cost**

### General comments

HoTARAC strongly supports the development by the IVPB of guidance regarding the application of Depreciated Replacement Cost (DRC). This project could potentially provide useful information to valuers and accountants alike. This is particularly relevant for the public sector, given that assets may not generate cash flows, or if they do they may not reflect the service potential of the assets (e.g. heavily subsidised activities and price regulated industries).

HoTARAC accepts that valuations are undertaken for many purposes, and that financial reporting is just one of those purposes. However, HoTARAC is concerned that, developing generic guidance applicable for differing purposes, could potentially lead to ‘rules’ rather than guidance and give rise to greater potential for confusion and inconsistencies. It is recommended that, consistent with the feedback on the Discounted Cash Flow valuation Technical Information Paper (TIP), a section be included within the DRC TIP covering its application to valuations used for financial reporting purposes.

Further, consistent with previous HoTARAC comments to the IVSB on the ED Proposed New International Valuation Standards, HoTARAC believes that any IVSC / IVPB guidance should clearly acknowledge the respective authority of Accounting Standards and cross reference the relevant requirements. As drafted, the proposed TIP in many areas seems to paraphrase similar Accounting Standard requirements but without referencing them or without making clear where or if they are different from Accounting Standards. HoTARAC also notes that the IVPB has omitted the sub-section ‘Relationship to Accounting Standards’ from the current Guidance Note 8. HoTARAC does not support this change.

HoTARAC also strongly encourages the IVSC / IVPB to continue to work in close consultation with the International Accounting Standards Board (IASB) on matters impacting on financial reporting.

In particular, further consultation may be required with the IASB regarding the proposed treatment of borrowing costs and the entrepreneurial profit margin, to clarify whether these proposals will be consistent with IFRS 13 *Fair Value Measurement*. HoTARAC is also concerned that extending the concept of economic obsolescence to incorporate discounted cash flows seems to mix two different valuation approaches (the cost approach and the income approach) and this is not consistent with the TIP 2 objective of providing guidance on applying the DRC method.

A number of other issues may be clarified by the IVPB outlining the primary purpose of a DRC valuation. This could include examining the differences that arise in the context of a market value / fair value or value in use valuation (e.g. market assumptions, entity specific inputs and entry and exit prices).

These and other issues are further discussed in the detailed comments attached.
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?

Yes. However, HoTARAC notes that the ED purports to apply to a ‘variety of different bases of value’, not just market value. In this regard, HoTARAC is concerned that, in attempting to develop generic guidance applicable to all bases of value, the application of DRC for financial reporting purposes becomes less clear, with greater potential for confusion and inconsistencies.

In particular, HoTARAC is unclear whether, or to what extent, the guidance is equally applicable to the different bases and purposes of valuation (as referred to in draft TIP, paragraph 1), given that the draft Framework comments that: “The nature and source of the valuation inputs should reflect the basis of value, which in turn depends on the valuation purpose” (draft Framework, paragraph 70).

HoTARAC believe that the TIP should be more explicit about how the concept of DRC may vary depending on the bases and purpose of valuation. Specifically, HoTARAC is concerned that there are no cross references to relevant Accounting Standards, and no commentary as to whether or not the guidance is consistent with the Accounting Standards. For these reasons, HoTARAC does not support the omission of the section of ‘Relationship to Accounting Standards’ which is in the current Guidance Note 8. This is further discussed in the responses to questions 3 and 4 and ‘other comments’ below.

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.

HoTARAC supports the alternative view that DRC is the only appropriate method of applying the cost approach. As DRC is a current value approach, applying the historical cost method would not be appropriate. In addition, this is consistent with IFRS 13, which provides that the ‘cost approach’ is often referred to as ‘current replacement cost’ (refer IFRS 13, paragraph B8). HoTARAC regards reproduction cost as a special case of current replacement cost, where the service potential of the asset is embodied in its exact form, rather than as an alternative valuation method for market value.
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?

HoTARAC supports the term ‘economic’ obsolescence, as it is consistent with IFRS 13.

However, HoTARAC is concerned that the proposal in paragraph 41 of the draft TIP is conceptually incorrect and may be seen to incorporate a cash flow impairment test as part of the DRC calculation. This seems to mix two different valuation approaches (the cost approach and the income approach).

Further, HoTARAC notes that both IFRS 13 and the IVS (refer draft IVS Framework) refer to the income and cost approaches as separate valuation approaches. Including economic obsolescence based on cash flows within DRC effectively confuses two different valuation approaches. HoTARAC believes that, while economic obsolescence is relevant to both the cost and income approach, it should be incorporated differently depending on which valuation approach is applied. That is, for DRC, economic obsolescence should be incorporated as part of the assessment of useful life (refer IAS 16, paragraph 56) or the depreciation method (e.g. accelerated depreciation rate) while, for the income approach, economic obsolescence should be incorporated as part of the cash flows (i.e. similar to IAS 36, paragraphs 12(e) and 14).

HoTARAC also believes that for financial reporting purposes, the draft TIP needs to clearly distinguish between ‘fair value’ (i.e. market exit price) and ‘value in use’ (i.e. an entity specific value). For example, IAS 40, paragraph 49, provides that:

“Fair value differs from value in use, as defined in IAS 36 Impairment of Assets. Fair value reflects the knowledge and estimates of knowledgeable, willing buyers and sellers. In contrast, value in use reflects the entity’s estimates, including the effects of factors that may be specific to the entity and not applicable to entities in general….”

The draft TIP illustrative examples provide that ‘to the extent economic obsolescence is identified it is likely that the value of any identifiable intangible assets would have already been impaired’ (third paragraph under illustrative examples). HoTARAC believes this statement should be clarified to reflect the requirements of IAS 36 that an impairment loss is first allocated to goodwill, then pro-rated over the remaining assets of a cash generating unit (paragraph 104).
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?

In principle, HoTARAC agrees that a cost approach that does not include all forms of obsolescence is not a measure of market value (or fair value under Accounting Standards).

Other comments

Depreciated Replacement Cost

HoTARAC notes that IFRS 13 uses the term ‘current replacement cost’ rather than ‘depreciated replacement cost’. It is suggested that the IVPB reviews the relationship between the term DRC and ‘current replacement cost’, to highlight any difference and avoid any confusion about the terms. Confusion may arise with using the term ‘depreciated’ replacement cost, because the term ‘depreciated’, as used in the draft TIP (refer paragraph 22 of the draft TIP), is based on a broader concept of ‘depreciation’ compared to the accounting standards. Similarly IFRS 13 provides that ‘obsolescence’ is broader than depreciation for financial reporting purposes, but unlike the draft TIP, IFRS 13 does not use the term ‘depreciation’ to describe ‘obsolescence’. This would be relevant particularly for public sector entities requesting a DRC valuation for specialised assets for financial reporting purposes.

DRC versus Income Approach

The draft TIP makes the comment that it is often difficult to apply the sales or income approach to specialised assets (paragraph 7 of draft TIP). HoTARAC generally agrees with this comment. However, HoTARAC recommends that the TIP also contemplates the situation where the income approach may also be available; i.e. where the ‘asset’ or ‘unit of account’ being measured is the CGU.

Further, HoTARAC notes that paragraph 59 of the draft TIP suggests that DRC is used for tariff setting purposes, including water infrastructure, power stations etc. However, this is often not the case in Australia, where many regulators have moved away from DRC and instead adopt a roll forward model (from a ‘line in the sand’ DRC). In these circumstances, arguments have been made that the income approach (based on regulated cash flows) is a more appropriate basis to determine fair value for financial reporting purposes, where the ‘asset’ is defined at the CGU level.
**Entrepreneurial profit margin**

HoTARAC believes that additional clarification is required regarding the ‘entrepreneurial profit margin’ (paragraph 16 of the draft TIP) and how this is consistent with a DRC approach which is based on the “cost to obtain an asset of equal utility, whether by purchase or by construction” (paragraph 2 of the draft TIP) (italics added). This may also require further discussion regarding any differences between an entry or exit value and the concept of market value or fair value. Consistency with IFRS 13 should also be considered.

However, if the entrepreneurial profit margin is included, it is not clear whether it is possible to reliably measure the margin where unobservable inputs are used (referred to as level 3 inputs in IFRS 13). Clarification on this matter would assist.

Further, where paragraph 18 of the draft TIP refers to the ‘entrepreneurial profit margin’ as the element that “…represents the amount of economic benefit required to motivate the asset owner to create the asset” it is unclear whether this component should be included in DRC under all bases of value (refer also response to question 1).

**Modern equivalent asset**

HoTARAC believes that the term ‘modern equivalent asset’ should be referred to in the draft TIP, paragraph 11 definition of ‘replacement cost’. This is also necessary to be consistent with the discussion of the cost approach in the staff draft of the IVSC Framework in paragraphs 63 and 64.

**Optimisation**

HoTARAC believes that additional guidance should be provided about ‘optimisation’ in the valuation process (refer draft TIP, paragraph 35), including the distinction between the concept of incremental optimisation (i.e. which is limited to the extent it can occur in the normal course of business using commercially available technology) and ‘greenfields’ optimisation (i.e. which assumes the design of an entirely new optimal network of assets for the entity).

**Borrowing costs**

The treatment of borrowing costs as part of a DRC calculation is to be examined in Australia and New Zealand for not-for-profit entities, where there is currently a choice whether to expense or capitalise borrowing costs. Therefore, HoTARAC suggests this issue be further discussed by the IVPB with the Australian and New Zealand Standard setters, to determine whether the inclusion of finances cost in valuations for financial reporting purposes is appropriate.
Cross references to IVSC and Framework

HoTARAC believes that the TIP should include cross references to the draft IVSC Framework and relevant IVS, including IVS 300 on *Valuation for Financial Reporting*. This is necessary to clarify the meaning of certain terms in the TIP, which in isolation may be misinterpreted or unclear; e.g.:

- The term ‘market value’ and ‘fair value’ is used differently for valuation purposes, compared to financial reporting purposes.
- The term ‘highest and best use’ is used in the TIP, without making it clear that the term refers to the higher of the existing use and feasible alternative use (i.e. a use that is physically possible, financially feasible and legally permissible).

Not-for-profit entities

In contrast to GN 8, the draft TIP does not acknowledge that in the public sector, assets may be held for service delivery rather than profit. Therefore, in such circumstances impairment testing, based on discounted cash flows, is not appropriate. While this is discussed in draft IVS 300, there is no acknowledgement or cross references by the TIP to IVS 300.

Specifically, paragraph 45 of IPSAS 21 *Impairment of Non-Cash Generating Assets*, provides for the use of the DRC in measuring value in use for assets that do not generate a commercial rate of return.

Additionally and as mentioned above, for the not-for-profit sector, which includes the public sector, specific circumstances are provided for under the Australian Accounting Standards ‘where the future economic benefits of an asset are not primarily dependent on the asset’s ability to generate net cash inflows and where the entity would, if deprived of the asset, replace its remaining future economic benefits, value in use shall be determined as the depreciated replacement cost of the asset.’ (AASB 136 *Impairment of Assets*, paragraph Aus 32.1).