May 31, 2011

International Valuation Professional Board
41 Moorgate
London EC2R 6PP
United Kingdom

Re: Technical Information Paper 2
Depreciated Replacement Cost

Dear Sirs:

Attached for your consideration in Attachment 1 are our responses to the Questions for Respondents, as well as specific comments on the language in the TIP Exposure Draft in Attachment 2.

As stated on page 2 of the TIP Exposure Draft, the International Valuation Professional Board is preparing a series of these TIP’s to assist valuation professionals in identifying best practices and to promote consistency of practice. As a firm of valuation professionals, American Appraisal supports these efforts thoroughly.

There are four issues related to the Depreciated Replacement Cost, however, that should be addressed in greater detail.

The first issue is the interplay between the starting point of the analysis (replacement cost or reproduction cost) and the concept of functional obsolescence. The American Society of Appraisers has treated one element of functional obsolescence, excess capital cost, as the difference between replacement cost and reproduction cost. But it has also identified excess operating expenses as an element of functional obsolescence. The TIP needs to address these points more fully.

The second issue which requires further guidance and commentary is the allocation of economic obsolescence to individual assets. As stated, EO may be measured by reference to the performance of the whole business or cash generating unit. The unit of valuation for financial reporting and tax purposes, however, is often the individual components of a manufacturing facility. The components should not be adjusted below their market value determined under a sales comparison approach.
The overall EO percentage cannot be applied pro rata, as floor values of specific components could be violated. More guidance in dealing with this issue would be helpful.

The third issue is when to use the DRC method. The TIP states that the DRC method is most commonly used for the valuation of specialized assets. We suggest that the DRC method be considered especially when the following factors exist:

- transaction data about the value of an asset is limited
- cash flows specifically related to the asset are not separable from other assets, and
- the depreciated cost of recreating the asset can be estimated with a reasonable degree of certainty.

Lastly, the TIP suggests including interest cost during construction and entrepreneur’s profit when determining replacement cost. While the TIP provided sufficient guidance for calculating interest cost, more discussion and guidance for calculating entrepreneur’s profit is needed.

Again, we support your efforts to improve the quality and consistency of valuation analyses. The suggested changes are intended to improve the quality of the guidance you are providing. Please consider including them in the final version of the TIP.

Sincerely,

American Appraisal Associates
ATTACHMENT 1

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?

Yes. 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.

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.

The Cost Approach is typically described as the Depreciated Replacement Cost (“DRC”) method. But, as paragraph 11 correctly points out, the starting point of the DRC method is to establish the nature of the equivalent asset that the hypothetical buyer would consider as an alternative to the asset being valued. This, in turn, determines whether a replacement cost or a reproduction cost should be used in determining the cost of the alternative asset. If “Depreciated Replacement Cost” is intended to cover both replacement cost and reproduction cost, then it is our opinion that the depreciated replacement cost is the only method of applying the cost approach.

3. In this Exposure Draft the term “external obsolescence” has been replaced with the term “economic obsolescence”. One view is that “economic obsolescence” is the more commonly used term. Another view is that “external obsolescence” more clearly requires all factors that arise from changes to the environment be considered. Which of these views do you support?

We support the view that “economic obsolescence” is the more commonly used term. And, since it is defined as “the loss in value caused by factors which are external to the asset itself”, it implies that all factors that arise from changes to the environment be considered.

4. 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?

Yes.
ATTACHMENT 2

Depreciated Replacement Cost

Paragraph 1: The statement is made that the DRC method may be used to estimate a variety of different bases of value. It is our opinion that there are fundamentally only two bases of value: fair value (or fair market value or market value) where market participant assumptions are used to value an asset, and investment value (or special value) where entity-specific assumptions are used. An example of adjustments necessary to develop fair values and investment values under the DRC method for the same asset would be helpful.

Paragraph 4: The statement is made that the DRC method is most commonly used for the valuation of specialized assets, but there is no definition for “specialized assets”. A better starting point may be to say that the DRC method is most commonly used to value assets for which comparable sale information is not available, an income stream cannot be ascribed, and the cost of recreating the asset can be estimated with reasonable certainty. Then give examples of tangible assets (specially designed equipment, unique production facilities) and intangible assets (back-office software) which are valued by the DRC method.

Paragraph 10: We do not agree with this statement. If the asset were redundant or obsolete, the DRC method can still be employed, but with a larger allowance for either functional or economic obsolescence.

Paragraph 13: This paragraph confuses the distinction between reproduction cost and replacement cost, and should be rewritten. If the asset is nearly new, the reproduction cost and replacement cost should be equivalent. And if the exact design and features of an asset were an integral part of the benefit that would accrue to an owner, the owner would replace the asset with an exact replica. Here again, replacement cost would be equivalent to reproduction cost.

Paragraph 18: More specific guidance is needed to determine when entrepreneurial profit should be considered, and how it may be estimated.

Paragraph 19: The discussion on Componentization should make reference to the IFRS requirement to componentize assets for financial reporting purposes.

Paragraph 21: The term “techniques” should be used here rather than “approaches”. The term “approaches” should be limited to references to the cost, market, or income approaches. And
a more granular componentization technique “may” produce a more robust valuation outcome, rather than “will be likely to”.

Paragraph 25: The term “total physical life” is undefined, although the term “physical life” is defined in paragraph 46. We suggest that the term be used consistently, and that the discussion of physical life and economic life be addressed here, rather than in paragraph 46.

The last sentence should be deleted, as it does not add to understanding the issue.

Paragraph 27: Functional obsolescence can be present in two forms: excess capital costs and excess operating costs. It should be made clear that excess capital costs can be addressed in one of two ways: a reduction to reproduction cost, or the use of replacement cost as a starting point.

Paragraph 29: Additional example of excess operating costs:
- Higher energy consumption than a current replacement.

Paragraph 33: We assume that this statement addresses a “bottleneck” situation, but further explanation of how this should be addressed in the valuation is needed.

Paragraph 35: The relevance of this paragraph is unclear. How does optimization affect the valuation of the assets?

Paragraph 39: This paragraph should be revised to indicate that one potential element of EO is inutility (actual operating level vs. rated capacity), but that this may capture only a portion of EO. There can be significant EO in cases where no inutility exists.

Paragraph 41: We suggest changing the last clause from “other present value techniques” to “other business valuation approaches”.

Paragraph 42: The potential methods of allocating EO across individual assets, without violating floor values, needs to be addressed more fully.

Paragraphs 45 – 53: These paragraphs under the heading “Asset Life” seem to address the subsequent accounting for the asset, rather than the valuation of the asset. They confuse the issue of Physical Deterioration, discussed above, and could be eliminated.

Paragraphs 55 – 58: The paragraphs addressing “highest and best use” should be harmonized with IFRS 13 “Fair Value Measurements and Disclosures”, which implies that the entity’s intended use of the assets is deemed to be their highest and best use. A good example is a
manufacturing facility on the periphery of a commercial / residential area. If purchased by another manufacturer, the land would be valued as industrial land, the building using DRC, and the M&E using DRC and sales comparison data. If purchased by a real estate developer, the land would be valued as commercial / residential land less costs to demolish the building, the building would have no value, and the M&E would be valued at scrap or liquidation value.