3 June 2011

M. Jean-Florent Rérolle  
Chairman  
International Valuation Professional Board  
41 Moorgate  
LONDON EC2R 6PP  
UNITED KINGDOM  

Dear M. Rérolle  

**Proposed Technical Information Paper 2 Depreciated Replacement Cost**

The Australian Accounting Standards Board (AASB) is pleased to provide its comments on IVSC Exposure Draft ‘Proposed Technical Information Paper 2 Depreciated Replacement Cost’ (ED TIP 2). Given the AASB’s interest in depreciated replacement cost (DRC) is from a general purpose financial reporting perspective, we have focused primarily on whether the proposals in ED TIP 2 are consistent with the guidance on using DRC as an estimate of the fair value of assets in general purpose financial statements that comply with International Financial Reporting Standard IFRS 13 *Fair Value Measurement* (May 2011).

**Overall comments**

The AASB considers that ED TIP 2 is a positive step in providing valuation guidance that can support estimates of the fair value of assets used in financial reports prepared under International Financial Reporting Standards (IFRSs). However, the AASB queries whether the proposed TIP 2 would provide sufficient guidance to help ensure valuations conform to IFRS 13 when prepared to apply the cost approach to measure fair value under that Standard. This is important because the cost approach is used to measure the fair value of a wide range of assets. Examples of where additional guidance would be helpful are set out in Appendix B to this submission.

The AASB would prefer that IVSC limits the scope of the proposed TIP 2 to guidance for applying the cost approach to measure fair value under IFRS 13, and indicates how that guidance relates to the specific requirements in IFRS 13. The AASB also would prefer that any different valuation guidance on DRC for other purposes be provided in other IVSC documents. However, if the IVSC confirms its proposal that TIP 2 includes guidance on measuring DRC for other purposes, TIP 2 should explicitly identify any guidance that is inconsistent with IFRS 13. The AASB suggests that the IVSC works with the IASB in this regard, consistent with the decision of the International Valuation Professional Board in March 2011 to discuss with the IASB how IVSC may assist in developing educational material to support application of IFRS 13.
**Potential inconsistency with IFRSs**

The AASB is concerned that ED TIP 2 contains a potential inconsistency with International Financial Reporting Standard IAS 36 *Impairment of Assets* that creates a risk that valuations under the proposed TIP may be inconsistent with the outcome of correctly applying IFRSs. ED TIP 2 has a possible implication that, in determining the DRC of assets within a group of assets, economic obsolescence is likely to be allocated to identifiable intangible assets before tangible assets (see the ‘Illustrative examples of economic obsolescence’, in the third paragraph on page 15 of ED TIP 2). 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 (paragraph 104).

The AASB considers that this principle in IAS 36 is also appropriate for determining fair value under IFRS 13, for the following reasons. ED TIP 2 implicitly makes an arbitrary assumption that identifiable intangible assets are more likely to suffer economic obsolescence than tangible assets. However, sometimes identifiable intangible assets can be sold or redeployed more readily than tangible assets, which may be fixed in location. In addition, businesses customarily use tangible and identifiable intangible assets jointly to generate net cash inflows, with the result that net cash inflows could only arbitrarily be assigned to particular assets within cash-generating units.

The AASB would agree with ED TIP 2 on this issue if its reference to ‘identifiable intangible assets’ were instead a reference to goodwill.

The AASB’s specific comments on the questions in ED TIP 2 are set out in Appendix A to this submission. Other comments of the AASB on ED TIP 2 are also set out later in Appendix A.

If you have any queries regarding any matters in this submission, please contact me or Jim Paul (jpm@aasb.gov.au).

Yours sincerely,

Kevin M. Stevenson
Chairman and CEO
APPENDIX A

SPECIFIC COMMENTS OF THE AASB ON ED TIP 2

Answers to Questions for Respondents

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<tr>
<th>Q1</th>
<th>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?</th>
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<td>The AASB does not express a view on this question because its remit is limited to general purpose financial reporting issues. Nevertheless, the AASB reiterates its comments in its covering letter that:</td>
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<td>(a)</td>
<td>it would prefer that the IVSC limits the scope of the proposed TIP 2 to guidance for applying the cost approach to measure fair value under IFRS 13; and</td>
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<td>(b)</td>
<td>if (a) is not agreed with, it is essential to clearly identify any guidance on depreciated replacement cost (DRC) in TIP 2 that is incompatible with applying the cost method of determining fair value under IFRS 13. Otherwise, valuations performed for the purpose of determining fair value under IFRS 13 might inadvertently be inconsistent with that Standard.</td>
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<th>Q2</th>
<th>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.</th>
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<td>The AASB’s answer to this question is provided only in the context of applying the cost approach to measure fair value under IFRS 13. Properly defined, DRC is sufficiently robust to cover all applications of the cost approach, and therefore should be regarded as the only method of applying the cost approach. The AASB observes that in relation to applying the cost approach to measure fair value, IFRS 13 refers only to current replacement cost, which would be compatible with DRC.</td>
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If TIP 2 were to retain the position in ED TIP 2 that DRC is the most common, but not the only, method of valuation under the cost approach, the AASB considers that the other acceptable methods of applying the cost approach should be identified and explained. |
**Q3** 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?**

The AASB generally does not express a view on this issue, because it focused on whether the types of deduction for obsolescence identified in ED TIP 2 (regardless of how they are named) are appropriate and complete, and concluded that they are. The AASB observes that IFRS 13 refers to “economic (external) obsolescence”, accommodating both of the views discussed in Question 3, and suggests that the IVSC gives consideration to using the same expression as that in IFRS 13.

**Q4** 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?**

The AASB considers that valuations that do not reflect some forms of obsolescence are incompatible with measuring fair value under IFRS 13. It does not comment on the determination of ‘market value’ for other purposes, such as regulatory valuations, because its focus is only on consistency with IFRS 13 of valuations for general purpose financial reports.

**Other Comments**

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<td>11, 13</td>
<td>It is confusing that paragraph 11 of ED TIP 2 defines ‘replacement cost’ separately from ‘reproduction cost’. The ED generally refers to depreciated replacement cost, and therefore could be construed as generally excluding reproduction cost from application of the ‘cost method’. Excluding reproduction cost would make no sense if reproduction gives rise to the lowest current cost per unit of service potential. Sometimes there is no modern equivalent asset with which to replace the service potential embodied in an asset. The first sentence in paragraph 13 (which the AASB supports) notes the appropriateness of using reproduction cost to measure assets under the cost approach in some circumstances. /…</td>
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The AASB recommends that, to avoid the potential for confusion, TIP 2 should include an early explicit statement that, in some circumstances, ‘depreciated replacement cost’ is determined by reference to the asset’s reproduction cost. This would also place in context the comment in the last sentence of paragraph 13 that “In these circumstances, reproduction would be the only form of replacement …”.

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<td>22</td>
<td>The AASB is concerned that the last sentence of paragraph 22 says that “In the context of the DRC method, depreciation refers to adjustments made to the cost of an equivalent asset to reflect any comparative obsolescence that affects the subject asset …”. Given that paragraph 23 refers to obsolescence as a component of depreciation that is separate from physical deterioration, the AASB is concerned that the last sentence of paragraph 22 may signify that an incomplete notion of depreciation should be used when measuring DRC under the cost approach. The AASB recommends amending paragraph 22 to be clear that depreciation for DRC purposes is as broad as depreciation as described in paragraph 23.</td>
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<td>47</td>
<td>The second sentence of paragraph 47 says residual value “may be equivalent to scrap or salvage value” (an exit price), or “a value that reflects the ability of the asset to contribute to the ongoing operation of a business with increased maintenance and operating costs”. The meaning of the second quoted phrase above is unclear. For example, is “the ability of the asset to contribute to the ongoing operation of a business …” reflected in a value in use notion, based on entity-specific circumstances? Or does that phrase relate to how to estimate the price other market participants would be prepared to pay for the asset at the end of its remaining life? This second meaning would be compatible with treating residual value as an exit price. If that phrase were intended to signify a value in use notion, it would be unclear why that interpretation of residual value is made. This is because an asset with a value in use should not have reached the end of its remaining life. The AASB supports treating residual value as an exit price. In addition, if that phrase were intended to signify a value in use notion, the AASB would be concerned that paragraph 47 does not clarify which of exit price and value in use should be regarded as residual value, or the circumstances in which one notion or the other should be used. This would be of concern because exit price and value in use are substantially different notions. In addition, the AASB found the reference to “increased maintenance and operating costs” unclear, because those costs are outflows, although residual value (being a deduction from the gross replacement cost to determine the depreciable amount) is generally an inflow notion. Based on these concerns, the AASB recommends clarifying the meaning of residual value in paragraph 47.</td>
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APPENDIX B

EXAMPLES OF ADDITIONAL GUIDANCE NEEDED

As mentioned in the AASB’s letter on ED TIP 2, the AASB considers that additional guidance should be included in TIP 2 to help ensure valuations conform to IFRS 13 *Fair Value Measurement* when prepared to apply the cost approach to measure fair value under that Standard. Examples of where additional guidance would be helpful are:

(a) to clarify that the use of DRC is not dependent on whether the entity’s management intends to replace the asset being valued. Consistent with this, guidance should be added that, if some components of network assets (such as cuttings made to build highways) are not expected to require future replacement (due to an absence of physical deterioration and negligible prospect of economic obsolescence), their replacement is nonetheless assumed when measuring the assets’ DRC;

(b) in relation to paragraph 12 of ED TIP 2, adding guidance on adjusting the replacement cost of a reference asset with a different capacity or capability than that of the asset being valued at DRC;

(c) in relation to paragraph 14 of ED TIP 2, adding guidance on when to apply price indexes to estimate DRC, and on the appropriate indexes to select in various circumstances; and

(d) guidance on measuring the DRC of assets held specifically as standby assets, for example, standby generators in an electricity supply business.