31 May 2011

Our Ref: DR/MP/Valcorr.

International Valuation Standards Council  
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Email: ivsc@ivsc.org

Dear Sirs

Re: Exposure draft - Technical Information Paper 2 - Depreciated replacement cost

RICS has noted with interest the publication of the draft Technical Information Paper (TIP) on Depreciated Replacement Cost (DRC) and welcomes the opportunity to comment. We have consulted colleagues globally and have discovered that although the broad principles of the cost approach are agreed there is a different approach to the actual process of establishing the cost in the North Americas.

Our response includes a number of comments and for convenience we make a broad observation followed by comments on the four questions and detailed comments on the draft.

We note that, in common with the new IVS generally, this paper refers to ‘assets’ so as to include not only structures and buildings but also any other form of asset, for example Plant and Equipment, for which the DRC approach may be applicable. In principle this is endorsed. However, we then find that the paper appears to refer to specific types of assets in a few places, rather to assets generally, giving rise to the potential for misunderstanding. Our comments identify the specific instances.

Question 1

The cost approach is means of arriving at a market derived value by reference to current new cost. We agree that DRC is a method of valuation that may be used in many circumstances and it should not be limited to use in providing valuations for financial statements. We are aware that the method is widely used in markets where there is little transactional information. The draft is correctly limited to explaining the principles.
Question 2

DRC is a derivative of the cost approach and we agree that it should not be seen as the only method to be adopted where a cost approach is used. For example the approach mentioned in question 4 is also a cost method, albeit qualified.

Question 3

We agree that the term 'economic' is preferable to 'external'. RICS has recently made a similar change in its guidance on the method.

Question 4

We agree with your comment that a cost approach valuation that is precluded from considering all forms of obsolescence does not represent market value. The answer to the tariff setting question will depend on whether or not the regulatory body adjusts the tariff for obsolescence (or any other factor), or not, as part of its regulatory structure. Where a valuation is provided for inclusion in a tariff formula it must be adjusted to avoid double counting and an appropriate explanation given but it may then not be a 'true' DRC valuation.

Detailed comments on the draft

Title Page

The title “Depreciated Replacement Cost” is potentially misleading as it implies that only the “replacement” version of a cost approach is considered, which is problematic. While we recognise both the “replacement” and “reproduction” versions of a cost approach are discussed later in the document, we recommend the title of “Cost Approach” as it avoids implying that a “reproduction cost” analysis is somehow set aside.

Para 3

In our standards we make clear that ‘depreciation’ within DRC does not have the same meaning as depreciation in financial reporting. It is suggested that the end of this paragraph be extended to read: ‘... known as valuation depreciation (not to be confused with accounting depreciation)’

Para 4

Revise the first sentence to read: ‘... specialised assets, or assets traded in isolation from a wider concern’

Para 5

Revise to read: ‘... and installations, plant, machinery and equipment, as well as ...’

Para 7

Revise the first sentence to read:

‘For this reason it is sometimes difficult to apply the income approach as the primary approach to the valuation of individual specialised assets.’
Revise the second sentence to read:

'The income approach can however often provide a useful ...'

Para 9

At end of first sentence insert: 'subject to a wider cross market check.'

Para 13

We have some concern about the comments in this paragraph when looking at a building, or other assets, that are of special historic interest and local statute or regulation requires it to be replaced. Such a requirement could make the market value minimal and we recommend that some comment be added to cover this point.

Para 14

At the end insert: 'as it may not fully reflect technological and other market factors. Hence, it will rarely be as accurate as a current cost benchmark'.

Para 16

Insert new bullet at end '• Non recoverable taxes (to market participant)'

Para 17

After the bullet points insert: 'Care must be taken not to double count interest during construction in the event it is not expressed as part of the capital cost of acquiring an asset/accounting treatment of market sector participants'.

Para 34

Add new sub paragraph: 'A reality check should also be made to ensure that the market sector will support the cost of buying new, modern equivalent assets, i.e. if the sector earnings cannot actually support replacement of aged assets with new, and participants tend to buy used assets / extend the life of existing assets. This situation needs to be examined in parallel with economic obsolescence (see 40-42, 44 and 53).

Para 37

It is considered that, as written, this paragraph can be interpreted as requiring the valuer to make a forecast. We suggest this is revised to make it clear that it is the impact on the views of market participants of such factors that are material so far as they can be reflected on the date of valuation.

Para 39

This needs slight revision to confirm that it relates to a non-property asset if that is the intention.

Para 43

Revise to read: '... below its market value in isolation for alternative use outside its current usage/location, less costs'.
Para 45

It should be confirmed that the 'expected total life' should not be entity specific (although the views of the entity will still be relevant where such considerations may be reflected in financial statements).

Para 47

(a) It is not clear why reference is made in the first sentence to the residual value. This is relevant when considering accounting depreciation. If the comment relates to non-property assets this should be made clear.

(b) Revise first sentence to read: 'a residual market value in isolation at the end of their remaining life as determined above. This may be market determined or equivalent'.

Para 48

Add at end of last sentence: 'life-cycle of the asset / wider market practice.'

Paras 55 to 59

It is these paragraphs that have revealed a different approach in the North Americas where an ambiguity possibly results from a difference in the basis of value (eg, Market Value, Existing Use Value, Insurable Value, etc.), but may also be affected by the jurisdiction of practice and by the intended use of the value opinion.

Well before the introduction of international valuation standards any detailed guidance on the application of DRC had regard to the requirement under UK accounting standards that owner occupied property had to be recognised at what is known as 'Existing Use Value' (EUV). In simple terms this basis is a market value but with a special assumption that the use is limited to the actual use by the entity, and alternative uses are to be ignored. This led to the approach of land value being the identification of the value of land for a similar use as a final step in the calculation rather than the starting point.

In contrast, in the U.S. portion of the Americas Region when the basis of value is market value, the principle of consistent use drives the analysis of land value contribution in a cost approach, with the land being analysed under its highest and best use. The impact of any mismatch between the highest and best use of the improved property versus the highest and best use of the land alone is reflected in the contribution to value from the improvements.

While the total property value may be the same, there is a distinct difference possible in the contribution to value arising from the land versus the improvements within the total property. In the market value context, the remaining economic life of the improvements is also quite different. The latter is most common when the land use (in the eye of the market) is in transition or already has transitioned to a higher and better use and the improvements on the land are not matched to the current highest and best use of the land. This difference may be significant where an apportionment of the value is required for accounting for depreciation (where the land value is not depreciated).
Para 56

Market pressure usually results in a shortened remaining life span for the improvements in place. In an effort to eliminate the ambiguity, when the basis of value is market value, we strongly suggest the wording be revised to replace "may also be" in the first line with "is" – to read "When a market basis of value is required it is necessary ...".

Para 57

Revise final bullet to read: 'same use less all forms of depreciation'

Para 58

We suggest revising the second sentence to be clear that "It is particularly important when a market basis of value is to be reported to analyse the land under its highest and best use and reflect the economic impact on the improvements of any mismatch between the highest and best use of the land versus the existing use of the improved property, including how that mismatch affects the remaining economic life of the existing improvements on that land."

We trust that you find these comments useful but should you require further clarification or explanation please contact David Rusholme.

Yours faithfully

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