Dear Sirs

Exposure Draft (“ED”)
Proposed Technical Information Paper 2
Depreciated Replacement Cost (“DRC”)

We appreciate the opportunity to comment on the proposed ED to replace the current International Valuation Guidance Note No. (GN) 8 The Cost Approach for Financial Reporting issued by the International Valuation Professional Board (“IVPB” or the “Board”). We have consulted within the KPMG network in respect of this letter, which represents the collective views of the KPMG network. We have set out responses to the questions raised in the ED in Appendix 1 as well as other comments related to specific elements of the ED in Appendix 2. We offer general comments on the ED below.

Objectives of Technical Information Papers (“TIPs”)

We support the International Valuation Standards Council’s (the “IVSC”) efforts to provide standards and guidance to improve the quality and reliability of valuations. The IVSC has set out ambitious objectives for International Valuation Standards (“IVS”) and other material it or its subsidiary boards propose to issue. It has positioned IVS to be at the centre of efforts to achieve high quality valuations, supporting the public interest in financial reporting and capital markets, bank lending, etc.

We support the specific objectives of the IVPB’s TIPs “in identifying best practice” and “to promote consistency of practice”. However, we do not believe that the ED, as a standalone document, will achieve these objectives.
Level of proposed guidance

The guidance in the ED is at a high level in its discussion of a number of the application issues encountered in practice on DRC. Although we are supporters of principles based valuation standards, the principles in the ED are articulated at such a high level that they may not lead to different valuers addressing similar circumstances in a consistent manner. We believe that the incremental contribution of the material in the ED to valuation practice is positive but more limited than if a more comprehensive approach was adopted.

We understand that valuations involve the exercise of professional judgment and that high level application guidance should not prevent a valuation professional from applying appropriate judgment. We believe that the ED is only partially successful in meeting its objective of providing useful guidance that should result in professionals approaching similar circumstances with a common understanding and providing insight that results in a consistent approach to technical issues to improve the quality and consistency of valuations.

We have previously expressed similar concerns about the level of guidance in relation to the draft International Valuation Standards (“IVS”) and Technical Information Paper 1, The Discounted Cash Flow (DCF) Method – Real Property and Business Valuations and noted our hope that more comprehensive guidance would be issued as part of the TIPs or other IVSC material. We believe that the ED identifies a number of key issues and particularly welcome the use of illustrative examples. However, we believe that a more comprehensive treatment of issues and more examples would facilitate the TIP’s objectives.

We suggest that the IVSC reconsider the level of authority it proposes to apply to application guidance. While we believe that high quality guidance can achieve quasi-authority through professional recognition of the quality of such material, an ability to state that a valuation was prepared in accordance with IVS despite not complying with high quality application guidance is troubling and would not achieve the objective of improving the reliability of valuation reports.

Issues outlined in the TIP

Market value can be determined through use of the cost approach, the market approach and/or the income approach. Each approach to determining market value should be considered and applied if appropriate to the specific asset being valued. Within the cost approach, the depreciated replacement cost method is only one technique that may be utilized in the calculation of market value. The ED should state that valuation specialists should consider other approaches to value.

1 We believe that market value is largely identical to fair value under International Financial Reporting Standards (“IFRSs”). For simplicity and consistency with the terms used in the ED, we refer to market value in this letter.
In our experience, the DRC method is especially useful in the valuation of specialized assets or other assets where there is difficulty securing relevant comparable sales information. We believe that further best practice guidance would be useful to support consistent market value determinations using the depreciated replacement cost method.

The depreciated replacement cost of an asset can be calculated through the depreciated replacement cost method which estimates the replacement cost of an asset through the use of inflationary indices or other market based sources. Replacement cost is then depreciated to account for any loss in value due to physical deterioration, functional obsolescence, or economic obsolescence to arrive at a depreciated replacement cost. For example, physical depreciation can be estimated through an age/life analysis while functional and economic obsolescence must be determined through an analysis of functionality, operating costs, as well as any external economic factors. The TIP should include more direction on considerations when performing the depreciated replacement cost method such as:

- Appropriateness of the depreciated replacement cost method for particular assets or circumstances;
- Assessing replacement cost;
- Analyzing modern equivalents;
- Sources of replacement cost information;
- Estimation of an engineering life;
- Assessment of physical deterioration;
- Consideration of any legal framework;
- Assessment of functional obsolescence; and
- Assessment of external obsolescence.

Based upon the general methodology described above, the following should be focal points in the TIP and additional practical guidance should be included, addressing:

- The estimation of replacement cost should consider all modern replacements that provide equivalent utility to the assets being valued. Consideration should be given to the design and implementation of the current asset as it relates to operating costs and other asset specific discrete costs.

- The estimation of replacement cost and economic useful life should consider any major refurbishments, rebuilds, or other life extension projects that may represent significant capital expenditures (“CapEx”) into a facility. These projects can increase the expected useful life of a plant; however, they may not be additive to the total replacement cost conclusion.
The estimation of economic useful life should consider the total life of the asset and the owner’s ability to profitably utilize the asset.

Additionally, the estimation of economic useful life should consider planned and preventative maintenance programs as well as any historic CapEx that may either lengthen or shorten the remaining life of certain component systems and the overall life of the asset.

The estimation of depreciated replacement cost should consider any legal framework that may limit the economic useful life of a specialized asset.

The estimation of depreciated replacement cost should consider any variable costs based on the location of the asset.

The estimation of depreciated replacement cost should consider economic obsolescence through an analysis of the overall income stream associated with the subject asset to assess whether the cash flows expected from use of the asset supports the value derived through the cost approach.

The estimation of depreciated replacement cost should consider any recent sales of comparable facilities as support for the conclusions derived through the cost approach.

We strongly encourage the Board to consider additional guidance and illustrative examples in the final TIP. We believe a useful starting point for such material is the guidance produced by RICS International and/or the American Society of Appraisers, both of whom are members of the IVSC.

Please contact Andrew Smith at +1 302 528 1203 or Mary Tokar or Jim Calvert at +44(0)207694 8871 if you wish to discuss any of the issues raised in this letter.

Yours faithfully

KPMG IFRG Limited

KPMG IFRG Limited
Appendix I

Question 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?

Response: We agree. There are three approaches to estimate the market value of an asset. These are the cost approach, the income approach, and the market approach. All three approaches, if applied properly, should yield value conclusions which correlate and reconcile to each other.

Question 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.

Response: The depreciated replacement cost method is only one method used to apply the cost approach, albeit the most common. There are instances where a reproduction basis is applicable. While many market based inputs may be utilized within an application of the cost approach such as market evidence to support physical depreciable life, functional obsolescence, and economic obsolescence, the overall methodology is consistent with the cost approach.

Question 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?

**Response:** We support the term external obsolescence. External obsolescence can include factors above and beyond direct economic impacts such as new legislation and its impact on asset value, changes in the industry, as well as changes in economic factors. These items all fall under the realm of external obsolescence, which includes but which is not restricted to economic obsolescence.

**Question 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?

**Response:** We agree.
## Appendix II

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<thead>
<tr>
<th>Ref</th>
<th>Page</th>
<th>Paragraph</th>
<th>Issue</th>
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<tbody>
<tr>
<td>1</td>
<td>6</td>
<td>11</td>
<td>A distinction should be noted that the difference between replacement cost new and reproduction cost new is “excess capital”.</td>
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<td>2</td>
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<td>The paper should be limited to a) market value basis of value; b) all types of property, plant, and equipment; excluding land and intangible assets; and c) an “in-use” premise of market value or the effect of these items separately discussed. (The document mentions consideration of the soft costs required to install and make an asset operational. These costs are only applicable under an “in-use” premise. Under an “in-exchange” premise of market value, the purchaser will incur the costs required to make an asset operational.)</td>
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<td>Physical depreciation is incorrectly characterized as perhaps not being applicable if the service capacity of the asset is not impacted by the degree of physical deterioration. No discussion of curable vs. incurable depreciation is included which is important to the discussion.</td>
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<td>4</td>
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<td>Functional obsolescence is equated to technological obsolescence but the latter is a subset of the former. Excess operating costs are said to be captured via the present value of these costs; this is only true if they less than the cost to cure. A discussion of curable vs. incurable depreciation is not included with only a brief reference to cost to cure. If this point refers to excess capital under a replacement scenario then this is calculated in the replacement cost new calculation (refer to comment under reference 1.)</td>
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<td>5</td>
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<td>32</td>
<td>An in-utility penalty (excess operating capacity) is characterized as functional obsolescence and a cost-to-capacity method referenced. Excess operating capacity is a form of external or economic obsolescence, not functional obsolescence.</td>
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<td>Economic obsolescence – gross margin is defined incorrectly and declining gross margins are noted as a potential indicator of economic obsolescence but operating profit or debt-free cash flows are more</td>
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appropriate indicators.

The discussion of the excess operating capacity penalty appears to be based on a pro-rata calculation (excess capacity/total capacity equals penalty). In fact, the cost-to-capacity analysis mentioned on page 9, paragraph 32 should be referenced.

Paragraph 43 references the subtraction of costs for decommissioning and decontamination – but for accounting purposes there may be a liability established already.

A distinction needs to be made in the asset life discussion that these are valuation lives – not tax or accounting lives. In addition, implied remaining useful lives (RULs) resulting from a valuation analysis are only one of many factors to be considered in setting RULs for financial reporting purposes; a lifing study is a separate engagement/set of procedures.

The residual value is incorrectly described and inconsistent with the asset life definitions.