The Russian Society of Appraisers, a constituent of IVSC, has considered the IVPB Exposure draft of TIP 2 “Depreciated replacement cost” released in February 2011 and prepared its comments in consultation with the Russian Academy of Science’ Council on National Property Management Strategy, which we hereby present to the International Valuation Standards Council.

We applaud the ongoing standard-setting efforts of IVSC Boards and hope that IVSC will find these comments to be of assistance in their standard-setting activities.

Ms. Olga Ponomarenko,
RSA Public relations officer
07 March, 2011

Attachment: RSA Letter of Comment on TIP 2 “Depreciated replacement cost”
The Russian Society of Appraisers’ comments on The IVSC Exposure draft of Technical Information Paper 2 “Depreciated replacement cost”

The Russian Society of Appraisers (RSA) is pleased to submit its opinion in connection with The Technical Information Paper 2 consultation period.

While the general set-up of the Paper appears to be self-consistent and we welcome the broadening of the scope of the Paper as against its former restricted application exclusively to the financial reporting purposes, still the new scope of application seems far from clear: some words have been included indicating its sole or principal applicability to the specialized asset categories. Is it, in fairness, the only generally admissible application of what is essentially “the cost approach” – the approach which was formerly reckoned an independent approach on par with the other approaches to value (i.e. the market and the income approaches). Under Marshallian set-up in economic theory, the cost approach yields a long-term equilibrium value of market prices for reproducible goods. Does this type of fundamental economic value have any role to play in the determination of applied “market value” in the professional valuation world? If not, why not? This nowhere appears in the deliberations of the Paper. As a suggestion, it seems a good practice to start attaching a “rationale section” to document drafts appearing from IVSC – to borrow the best standard-setting experience from the IASB and, especially, FASB documents of the accounting world. On the face of it, the cost approach should aspire to especial relevance in the post-economic-crisis valuation set-up as a tool of evident choice for developing counter-cyclical market values not prone to destructive speculative components – and not only in respect of specialized assets. If anything, ignoring a special dimension of information provided by the cost approach, in the context of market valuation problems for general reproducible assets, is fraught with reducing the art of valuation (an exercise in value determination) to a mere tautological reproduction of reigning market prices and their recertification in valuation reports as values, nay, sometimes fair values. This severely circumscribes the functional reason-de-etre of professional valuation as a tool of public macroeconomic policy in respect of the regulation of property and business capital accumulation processes, which it innately is (otherwise there would be no point in standardizing it).
Thus, we encourage a wider application of the cost approach\(^1\) as a standard valuation procedure to be included in most valuation reports for reproducible assets and as an invaluable source of extra dimension to a valuation problem at hand. This is consistent with the methodological basis of professional valuation as framed in the United States during the period of Great Depression and, hence, with the coordination-of-three-approaches doctrine still notionally extant in the current international methodology for valuation. It is consistent with the Russian valuation practice enshrined in the national standard documents for the valuation profession (FSOs 1,2,3). What is more, it is consistent with the classical and neoclassical doctrine of economic theory, especially in the Marshallian sense. In line with this, our suggestion is to expand the scope of TIP 2 and to change its title to “The cost approach to (property) valuation”, instead of sticking with the “Depreciated replacement cost”. Otherwise, an apparent lacuna in the standard-setting and nomenclatural system breaks out in that the TIPs series proceeds straightaway to the DRC method but omits considering in its structure the higher-level approach context (which is but scantily addressed in the revised standards themselves).

We further turn towards addressing the points on which comments are specifically sought to be called forth from the constituents of IVSC:

**Q1. 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?**

**A1.** As appears from the foregoing, we warmly welcome this expansion of focus. But its evidence is still limited, and it didn’t unfold itself fully, in the Exposure draft as currently proposed.

**Q.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?**

**A.2.** The cost approach, if interpreted broadly, is a separate autonomous logic of inquiry into different valuation problems of universal significance, rather than a specific desiccated and highly technical tool of limited applicability to only specialized assets. Logically speaking, it is possible to identify 3 distinct strains within the cost approach, which are, for example, highlighted in Artemenkov (2008)\(^2\) – these are: cost approach in the past tense, cost approach in the present tense, and cost approach in the future tense.

**Q.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?**

**A.3.** Abstracting from the name changes which is a matter of taste, we are inclined to support the division of obsolescence into the three categories as a useful and illuminating device for illustrative and expository purposes. But it has to be noted that the mutual interrelationship between the last two categories of obsolescence (functional and external) should not be left out of sight in practical applications, nor the tripartite classification idealized as the last pronouncement of economic analysis writ in stone\(^3\). Indeed, strict adherence to the positivist (market data circumscribed) principles of valuation hardly permits the universally supportable

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1. And urge the appreciation of its separate autonomous logic, which usually fades away through manipulations with the rate of “entrepreneurial incentive” -- so as to make the result similar to the sales comparison approach.
3. E.g. it excludes “liquidity effects” due to aberrations in the market functioning, i.e. economic obsolescence can be further split up for components, -- as well as the functional obsolescence.
empirical decomposition of obsolescence into the 3 pigeonholes. In some applications it makes plain sense to follow the indecomposable “percent good factor” view on obsolescence (e.g. in (mass) appraisal of property for taxation). Furthermore, in numerous applications (e.g. in the insurance context) the accounting for obsolescence is left out altogether.

It is to be noted that what the “illustrative examples of economic obsolescence” (included in the Annexe to the Exposure Draft) achieve in fact, is to show how to derive an entity-specific value in use for subject specialized assets. This would not necessarily conform to the “market deductive processes” objective enunciated in par. 50 of the Exposure Draft (though it can be made to conform under certain assumptions, such as that of the “average efficient operator”).

Q.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?

A.4. It can go both ways, but we predominantly agree. The laudable presumption of this question is that it implies that normally the cost approach leads to, or informs, market value (without any further reservations). It also makes it out that the activities of professional valuation can be proactively applied to significant issues of macroeconomic context, such as tariff regulation. The latter purpose deserves a special treatment in the context of an application guidance related to “macroeconomic (or public) purposes of valuation activities”. There, the issues such as valuation of public sector assets for national entity accounts and the tariff regulation issues can be suitably and properly discussed.

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