



December 21, 2006

International Valuation Standards Committee
12 Great George St.
Parliament Square
London, SW1P 3AD
United Kingdom

Re: Comments on Consultation Draft on Improvements to GN8 – The Cost Approach for Financial Reporting

Dear Committee Members:

On behalf of the members of the Appraisal Institute, the Appraisal Standards Committee of the Appraisal Institute thanks you for this opportunity to provide comments concerning the Consultation Draft on Improvements to GN8 – The Cost Approach for Financial Reporting.

We find that the proposed amendments to GN8 will help to increase the understandability of the GN by both Valuer's and clients and we applaud you for the work you have performed on this.

In an effort to assist you with making this document even better we have developed the following comments that range from requests for further clarification to suggestions for minor improvements. We hope that you find these comments to be of assistance.

1. Use of the term "assessing"

The GN uses the term "assessing" in Sections 1.2; 5.2; 5.3; 5.4; 5.4.1; 5.5.4 and 5.10. In some countries "assessing" has connotations related to the taxation of property. In addition, IVS has a definition of "assessed value" which relates to the assessment, rating and/or taxation of property (IVS Seventh Edition, page 94).

We recommend that the word "assessing" in Sections 1.2; 5.2; 5.3; 5.4; 5.4.1; 5.5.4; and 5.10 be replaced with words that do not have its tax related connotations. See attachment 1 for proposed revisions.

2. Section 1.2 – Depreciated Replacement Cost

Section 1.2 describes "Depreciated Replacement Cost". A review of this Section and Section 4.0 suggests a common misunderstanding about the use of the cost approach: That it is the appropriate valuation methodology when "market data" is insufficient. The cost approach relies on "market data" concerning costs as well as accrued depreciation. It appears that what is really meant in these Sections is that the cost approach may be the more applicable valuation approach when comparable sales data is insufficient.

We recommend the following changes to help clarify the guidance provided by Section 1.2:

1.2 *Depreciated replacement cost* is an application of the cost approach **that may be** used ~~in assessing~~ **to determine** the value of specialised assets for financial reporting purposes, where direct market evidence is limited. **The depreciated replacement cost may be the more applicable valuation approach when comparable sales data is insufficient but sufficient market data exists concerning costs and accrued depreciation.** As an application of the cost approach, it is based on the principle of substitution.

3. Sections 3.2 and 3.3 - Entity

International Accounting Standards use term “entity” not “enterprise” and/or “business” for financial reporting. In the interest of harmonization with Accounting Standards it may be appropriate to delete the words “enterprise or” and “business or” from these Sections.

4. Section 3.5 - Definition of Adequate Profitability

Section 3.5 of the “Definitions” section of the GN contains the term “Adequate Profitability” but it contains no definition of this term.

We recommend that a definition of “Adequate Profitability” be added.

5. Section 3.6 - Service Potential

See comments to Section 5.11 below

6. Section 3.8 - Optimisation

We find that the definition of “Optimisation” may still be confusing especially to individuals who are not familiar with this term. The difference between “optimisation” and “functional obsolescence” isn’t clear. We would recommend that this definition be further clarified.

7. Section 5.1

The GN does not identify the cases where a valuer may undertake a valuation of a specialized property using the sales comparison approach and/or the income capitalisation approach.

We recommend that the GN specify that it would be possible to use these approaches if sufficient direct market evidence exists. See attachment 1 for proposed revisions.

8. Section 5.2

This Section provides that “In the absence of direct market evidence, depreciated replacement cost is regarded as an acceptable method of [determining] the value of specialised assets...” This statement could be incorrectly interpreted to mean that there needs to be a complete absence of direct market evidence before the depreciated replacement cost could be regarded as an acceptable method.

We recommend that the word “sufficient” be added in front of the words “direct market evidence”. See attachment 1 for proposed revisions.

9. **Section 5.3**

We recommend the following changes to help clarify the meaning of this Section:

In the application of *depreciated replacement cost*, the ~~The Valuer assesses~~ **should determine** the cost of a *modern equivalent asset* at the relevant valuation date. This may involve ~~assessing~~ **determining** the cost of having a suitable asset commissioned to order. The **depreciated** *replacement cost* needs to reflect all incidental costs that would be incurred, for example for design, delivery, installation and commissioning. See attachment 1 for proposed revisions.

10. **Section 5.4 - Clarification**

We recommend the following changes to help clarify the meaning of this Section:

In the application of *depreciated replacement cost*, the ~~The Valuer then assesses~~ **should determine** depreciation by ...

11. **Section 5.4 – Economic Obsolescence vs. External Obsolescence**

IVS indicates in several places that ‘economic obsolescence’ and ‘external obsolescence’ are interchangeable (IVS Seventh Edition, pages 165, 339, 343). The Glossary of Terms Section of IVS defines these terms as follows:

Economic Obsolescence – A loss in value due to factors outside the subject asset.

Economic obsolescence is also called external, environmental or locational obsolescence. Examples of economic obsolescence are changes in competition or in surrounding land uses like an industrial plant near a residential area. It is deemed incurable as the expense to cure the problem is impractical.

External Obsolescence – See Economic Obsolescence.

The IVS’s objectives include facilitating cross-border transactions and enabling valuers around the world to respond to the demands of international property markets. One way to help meet these objectives may be to try to consolidate terms. For example in regards to the terms ‘economic obsolescence’ and ‘external obsolescence’ it may be appropriate to choose one of these terms as the one to use.

In this case we would recommend that the term ‘external obsolescence’ be the one to use as term ‘external’ is more inclusive and it does not have the variety of connotations and uses that the term ‘economic’ has such as ‘economic life of the asset’ and ‘economic conditions’. ‘External’ is the more precise and descriptive term in this instance.

We recommend the following changes to the definitions of ‘economic obsolescence’ and ‘external obsolescence’:

Economic Obsolescence – **See External Obsolescence.**

External Obsolescence – **A loss in value due to factors outside the subject asset. External obsolescence has also been called economic, environmental or locational obsolescence although those terms are no longer current. Examples of external obsolescence are changes in competition, supply of raw materials (including utilities particularly fuel costs), labor costs, land charges or in surrounding land uses like an industrial plant near a residential area. It is deemed incurable as the expense to cure the problem is impractical.**

We also recommend the following changes to Section 5.4 and 5.5

5.4 ...Depreciation rates may be all-encompassing or analysed separately for:

- Physical deterioration
- Functional obsolescence
- ~~Economic~~ **External** obsolescence ...

5.4.3 ~~Economic~~ **External** obsolescence resulting from external influences may affect the value of the asset. External factors include changed economic conditions, which affect the **supply of and** demand for goods and services produced by the asset or the costs of its operation. **External factors also include cost and reasonable availability of raw materials, utilities (particularly energy related costs) and labor costs.**

5.5.4 an analysis of potential external changes that may effect the asset (to estimate ~~economic/~~**external** obsolescence); ...

5.5.7 sufficient knowledge to determine the impact of ~~economic/~~**external** obsolescence on the value of the improvements.

12. Section 5.4 – Functional Obsolescence vs. Technical Obsolescence

IVS indicates in several places that “functional obsolescence” and “technical obsolescence” are interchangeable. The Glossary of Terms Section of IVS defines these terms as follows:

Functional Obsolescence – A loss in value within a structure due to changes in tastes, preferences, technical innovations, or market standards.

Functional obsolescence includes excess capital costs and excess operating costs. It may be curable or incurable.

Also called Technical Obsolescence.

Technical Obsolescence – Term used by PP&E Valuers for Functional Obsolescence.

The IVS’s objectives include facilitating cross-border transactions and enabling valuers around the world to respond to the demands of international property markets. One way to help meet these objectives may be to try to consolidate terms. For example in regards to the terms “functional obsolescence” and “technical obsolescence” it may be appropriate to choose one of these terms as the one to use.

In this case we would recommend that the term “functional obsolescence” be the one to use as the term “functional” is the more precise and descriptive term in this instance.

See attachment 1 for proposed revisions to Section 5.5.3

13. Section 5.4.4

In the interest of increasing the enforceability of IVS for those bodies and/or organizations that need to enforce IVS and to increase the understandability of this Section we recommend the following revisions:

When valuing *specialised property* ~~it is not appropriate to~~ **the Valuer must not** depreciate the cost of replacing the land element.

14. Section 5.5

In the interest of increasing the enforceability of IVS for those bodies and/or organizations that need to enforce IVS and to increase the understandability of this Section we recommend the following revisions:

In the application of *depreciated replacement cost*, the Valuer ~~shall ensure that~~ **must consider** the key elements of a market transaction ~~have been considered~~. These include...

15. Section 5.5.3

See attachment 1 for proposed wording revisions to increase understandability of this Section.

16. Section 5.5.4

See attachment 1 for proposed wording revisions to increase understandability of this Section.

17. Section 5.6

See attachment 1 for proposed wording revisions to increase understandability of this Section.

18. Section 5.8

See attachment 1 for proposed wording revisions to increase understandability of this Section.

Also, this Section contains a reporting requirement. Should this Section be moved to Section 5.12 which contains reporting requirements or should the reporting requirement be repeated in Section 5.12?

19. Section 5.9

See attachment 1 for proposed wording revisions to increase understandability of this Section.

Also, this Section contains a reporting requirement. Should this Section be moved to Section 5.12 which contains reporting requirements or should the reporting requirement be repeated in Section 5.12?

20. Section 5.10

See attachment 1 for proposed wording revisions to increase understandability of this Section.

21. Section 5.11

This section, along with the definition of "service potential" in Section 3.6 suggests that property that houses a "not-for-profit public sector entity" should be valued differently, i.e., that the valuation of such facility should reflect the "entity's objectives" with regard to the use of the property. This is inconsistent with the principal of highest and best use, which is an integral component of a market value analysis. If market value is the objective of the valuation, such an approach is flawed. The whole concept of "service potential" does not work for a market value analysis.

If the IVS decides to revise this GN based on these comments see also whether revisions to Section 5.12 are also warranted.

22. Sections 5.12, 5.12.1, and 5.12.2

See attachment 1 for proposed wording revisions to increase understandability of this Section.

Thank you for considering our comments and recommendations. Should you have any questions, please contact the Appraisal Standards Committee's staff liaison, Brendan Donnelly, at 312-335-4409 or bdonnelly@appraisalinstitute.org.

Best regards,

(Electronic Copy – Original with Signature to be mailed)

Sherryl Andrus, SRA
Chair, Appraisal Standards Committee

Attachment: Draft GN8 with proposed revisions