Hong Kong Institute of
Certified Public Accountants
香港會計師公會

Our Ref.: C/FRSC

Sent electronically through email CommentLetters@ivsc.org

31 May 2011

International Valuation Professional Board
41 Moorgate
London EC2R 6PP
United Kingdom

Dear Sirs,

IVSC Exposure Draft of *Technical Information Paper 2 Depreciated Replacement Cost*

The Hong Kong Institute of Certified Public Accountants ("the Institute") is the only body authorised by law to promulgate financial reporting, auditing and ethical standards for professional accountants in Hong Kong. We welcome the opportunity to provide you with our comments on the captioned Exposure Draft (ED). Our responses to the questions raised in your ED are set out in the Appendix for your consideration.

We agree with the ED that the cost approach can be applied in a wide variety of circumstances in addition to financial reporting. However, we note that the ED is being drafted mainly based on the valuation for tangible asset and it is not certain whether the principle in this Technical Information Paper (TIP) is also applied to intangible asset. We understand that paragraph 5 of the ED has slightly mentioned that the Depreciated Replacement Cost (DRC) approach can also be applied to intangible asset; however, there is no further elaboration or guidance on the factors that should be considered in performing the DRC for intangible asset. We consider that it would be helpful if the IVSC can address this clearly in the final TIP.

We note that the TIP describes the difference between the equity value and the value of the company's identifiable assets and liabilities as "goodwill" in the illustrative examples of economic obsolescence, which we consider may not be consistent with IFRS. According to IFRS 3 *Business Combinations*, goodwill is recognised in a business combination as the excess of the aggregate of the fair value of consideration transferred (including the acquisition-date fair value of previously held interest) and the amount of any non-controlling interest recognised over the assets and liabilities recognised. Accordingly, the amount of goodwill recognised under IFRS may vary depending on various factors such as the acquirer-specific synergy included in the consideration transferred and the measurement choice of the non-controlling interest. To prevent confusion, it is recommended that the word "goodwill" should be replaced with another term such as "residual value" or "unidentified intangible" if the Board means to refer to assets that are not tangible assets.

We understand that valuations involve the exercise of professional judgement and that high quality application guidance should not prevent a valuation professional from applying appropriate judgement. However, we are aware that more practical

37th Floor, Wu Chung House,
213 Queen's Road East, Wanchai, Hong Kong
香港灣仔皇后大道東213號胡忠大廈37樓
Tel電話: (852) 2287 7228
Fax傳真: (852) 2865 6776
(852) 2865 6603
Website網址: www.hkicpa.org.hk
Email電郵: hkicpa@hkicpa.org.hk

implementation guidance would be welcomed by emerging economies in Asia as the use of cost approach is more often in those economies due to the immaturity of the market with a relatively lower level of liquidity and number of market participants. We have previously made similar comments in relation to the draft TIP on discounted cash flow and had expressed a hope that the IVSC can work closely with local valuation standard setters such as The Royal Institution of Certified Surveyors (RICS) in the UK and the Hong Kong Institute of Surveyors (HKIS) in Hong Kong in developing local practical guidance on certain asset classes such as real estate properties so as to ensure it is consistent with the underlying principles in the TIP when addressing specific legal and market conditions of different jurisdictions.

If you have any questions on our comments, please do not hesitate to contact me at ong@hkicpa.org.hk.

Yours faithfully,

Steve Ong, FCPA, FCA
Director, Standard Setting Department

SO/WC/jn

Encl.

Hong Kong Institute of CPAs

Comments on the IVSC Exposure Draft of *Technical Information Paper 2 Depreciated Replacement Cost*

<u>Question 1</u>

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?

Yes, we agree that the cost approach, if properly applied, can be used as one of the acceptable methods to arrive at market value for a variety of purposes other than financial reporting. As with the application of other methods it is important that a cross check be done to another method or methods to determine the reasonableness of the valuation especially if the valuation involves a range of outcome.

<u>Question 2</u>

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.

We agree that DRC is the most common method of valuation under the cost approach in arriving at the market value. However, we do not agree that the DRC is the only acceptable method of applying the cost approach. Under different situation, different bases of value may be required, for example, the valuation for statutory purposes precludes all forms of obsolescence while the replacement cost approach is more appropriate for insurance valuation purpose. It is noted that these cost approach are slightly different from the DRC and are not representing market value which includes market supply and demand factors. As the TIP (which focuses on DRC) is to replace GN8 (which is about Cost Approach and should be of a wider coverage), we consider it would be useful if the Board can clarify in the introduction section that there might be other applicable methods under different situations and for assets other than tangibles.

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?

We do not have strong view on either the use of the term of external obsolescence or economic obsolescence. We are of the view that as long as the concept is clearly defined in the standard and transparent to the users through relevant disclosures, that is the DRC should include the economic impact of the external environment; we consider that both of the terms are acceptable.

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?

Yes, we agree that a cost approach valuation that does not identify and quantify all forms of obsolescence is not a measure of market value as those are considered by market participants in normal commercial transactions.

~ End ~