# Comments on RICS Consultation on proposed DRC Guidance Note 2018

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# Comment Information

Document Section: Depreciated replacement cost method of … 1. Introduction **/** (no name) **/**

Comment ID: 2

Respondent: Chris Thorne - Valuology

Response Date: 16 Jul 2018

# Comment

**1. Introduction**

I support the issuance of valuation guidance separately from the UK Red Book on matters that are not directly concerned with the application of mandatory requirements. I have made this point in my representations on the current draft of the UK Supplement to the Global Red Book. In principle I therefore support the proposal to remove guidance on DRC from the UK Red Book and to reissue this as a GN with Global application.

However, insufficient editing has been carried out to the existing UKGN2 to make this "global" GN. Specifically, these are the continued references to the UK Red Book in paragraphs 1.1, 1.5, 6.3 and 6.5. Where there are specific variations from global guidance these should be referenced and explained only in the appropriate national supplementary standards, not in the global guidance, otherwise there will be confusion caused with the potential for inappropriate application of national variations in other jurisdictions.

Not only are the cross references in para 1.5 to UK VPGAs 1.5, 2.7 and 2.8 inappropriate, none of the referenced sections of the UK Red Book deal with the assumption of instant availability which is probably the main divergence of UK public sector valuation practice from global norms.

# Comment Information

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| Document Section | Depreciated replacement cost method of … 3. When depreciated replacement cost is u… (no name) / |
| Comment ID | 3 |
| Respondent | Chris Thorne - Valuology |
| Response Date | 16 Jul 2018 |

# Comment

**3. When depreciated replacement cost is used**

In the current UKGN2, paras 3.3 and 3.4 contain important guidance that just because an asset may appear to be specialised according to the definition, it does not mean that the DRC approach has to be used. Other methods may be applicable and may give a more reliable indication of value. DRC can also be used alongside other methods which may provide a useful cross check to assist the valuer, especially in assessing depreciation. This guidance has been omitted from the draft – I recommend it be reinstated.

Reinstatement of this guidance will help reinforce the point that DRC is part of a suite of tools and methods that the valuer may use to estimate different bases of value and does not sit in isolation. Historically there was a period when the then UK accounting standards did present DRC as an alternative reporting basis from (open) market value. This has never been the case outside the UK and with UK accounting across the private and public sector now aligned with IFRS it is no longer true there either. Nevertheless, there is still some residual thinking that DRC is a different sort of valuation and not just a method and this GN should aim to dispel that.

# Comment Information

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| Document Section | Depreciated replacement cost method of … 3. When depreciated replacement cost is u… (no name) / |
| Comment ID | 4 |
| Respondent | Chris Thorne - Valuology |
| Response Date | 16 Jul 2018 |

# Comment

**3. When depreciated replacement cost is used**

References to the “entity” in the current UKGN have been replaced with the “client”. This is inappropriate. The valuer’s client may not be the party that built or made alterations to the asset in question. Neither may the "client's" accounting policies be relevant to the appropriate valuation approach. The offending sentences need either rephrasing so that there is no need to reference the person or entity responsible or careful editing to correctly identify the appropriate party, eg either owner, client, occupier, etc etc.

## Comment Information

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| Document Section | Depreciated replacement cost method of … <br> 3. When depreciated replacement cost is u… (no name) ***/*** |
| Comment ID | 5 |
| Respondent | Chris Thorne - Valuology |
| Response Date | 16 Jul 2018 |

## Comment

**3. When depreciated replacement cost is used**

3.8 needs revisiting. In a global context it is too simplistic to state that the DRC method cannot be used for secured lending valuation. The problem from a lender's perspective is not the method used but the nature of the asset. Because DRC is normally used where there is no market evidence of sales or the income generating potential of the asset, it is the degree of specialisation, and the associated illiquidity and valuation uncertainty that may make the asset unsuitable as security. However, neither should it be for the valuer to make the decision as to whether an asset represents suitable security. A more suitable paragraph might be:

> *If a specialised property is being valued for loan security purposes, and the valuer has concluded that the DRC method is the only method that can be used, the valuer should take care to bring to the prospective lender's attention the fact that this is property that is rarely, if ever sold in the market separately from the business in occupation, and to draw attention the impact this has on the liquidity of the property and the increased valuation uncertainty arising from its specialised nature (see VPGA 10).*

A further point is that the inclusion of this paragraph in any form is not appropriate in a GN that is titled *"Depreciated replacement cost method of valuation for financial reporting."* Either the GN should stick just to financial reporting or be about the use of DRC more generally. I consider wider appreciation that DRC can be used for purposes other than financial reporting is important so favour deleting the reference to financial reporting from the title.

## Comment Information

Document Section Depreciated replacement cost method of …
5. Settling the terms of engagement and cl… (no name) /

Comment ID 6

Respondent Chris Thorne - Valuology

Response Date 16 Jul 2018

## Comment

**5. Settling the terms of engagement and client discussions**

A similar problem that highlighted for Section 3 (comment ID 4) arises from the changing of "entity" to "client".

## Comment Information

Document Section Depreciated replacement cost method of …
6. Assessing replacement cost / (no name) /

Comment ID 7

Respondent Chris Thorne - Valuology

Response Date 16 Jul 2018

## Comment

**6. Assessing replacement cost**

The references to the “instant build concept” in 6.3 and 6.5 are inappropriate in a global GN, see comment ID 2. This should be removed to the part of the UK Red Book dealing specifically with UK public sector valuation.

While this may not be an appropriate concept for discussion in a GN intended for global application, I also question the premise of the concept given that UK public sector accounting is based on IFRS. The fiction that an assumed replacement could be built instantly on the valuation date is included in the guidance at Section 7 of FReM (and presumably also in the CIPFA Code although I have been unable to check this) but has the reason or justification for this ever been questioned by RICS? It is a departure from the overriding principle that fair value reflects the price that would be agreed between market participants in an orderly transaction, as the time taken to construct a modern equivalent asset would not be ignored by those participants. While there may be a sound reason for this approach being adopted by those responsible for public sector accounting, it would be helpful for the guidance to explain these reasons to ensure that valuers do understand the required adjustment to the approach that would normally be adopted when valuing in accordance with IFRS 13.

Pretending that alternative modern equivalent could be available instantly when one does not exist misrepresents the actual cost that a buyer would face. It makes no more sense than pretending that a sales comparable used when applying a market approach is in a different location or is of a different size to the actual comparable.

The effect of allowing for the time it would take to construct a modern equivalent asset would mean an allowance would need to be made for risk and the cost of finance during the construction period, thus having the effect of increasing the nominal cost. However, since the costs would not be incurred on day one but over the period of construction there would be an offsetting effect as the present value of those future costs would be lower. In many cases this would mean that the overall impact of correctly looking at all the costs associated with procuring a modern equivalent asset is not material when compared with the fiction of “instant availability”, but in the case of large or complex assets could be. While the assumption of “instant availability” may have been adopted as it appears to be a useful expedient, given that the stated policy of public sector accounting in the UK is alignment with IFRS, is it appropriate to promote a valuation approach that may mean that reported fair values differ from the principles in IFRS 13?

## Comment Information

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| Document Section | Depreciated replacement cost method of …<br>6. Assessing replacement cost **/** (no name) **/** |
| Comment ID | 8 |
| Respondent | Chris Thorne - Valuology |
| Response Date | 16 Jul 2018 |

## Comment

**6. Assessing replacement cost**

6.4 is an unnecessary and unhelpful addition to the current UKGN2. The concepts of DRC are already explained in the GN, so it is redundant. Introducing another term "current gross replacement cost" alongside "modern equivalent asset" will introduce confusion as there will be some who read this as meaning that the principles for determining the cost of the modern equivalent asset previously discussed do not apply to specialised property. The paragraph should be deleted.

# Comment Information

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| Document Section | Depreciated replacement cost method of … 9. Assessing valuation depreciation / Remaining life / (no name) / |
| Comment ID | 9 |
| Respondent | Chris Thorne - Valuology |
| Response Date | 16 Jul 2018 |

# Comment

**Remaining life**

The reference in 9.23 to "useful economic life" is incorrect. It should be "useful life" - see also comment ID 27 on the concurrent UK Red Book draft.

# Comment Information

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| Document Section | Depreciated replacement cost method of … Reporting / (no name) / |
| Comment ID | 10 |
| Respondent | Chris Thorne - Valuology |
| Response Date | 16 Jul 2018 |

# Comment

**Reporting**

There are other inappropriate references to UK RICS standards or UKGAAP throughout this section (see comment ID 2).