Depreciated Replacement Cost – Consistent Methodology?

Frances Plimmer and Sarah Sayce
Kingston University
f.plimmer@kingston.ac.uk

DRC - a method of valuation, thus:

The current cost of reproduction or replacement of an asset less deductions for physical deterioration and all relevant forms of obsolescence and optimisation.

Specialized Properties:

- Property that is rarely sold in the market;
- Except by way of sale of the business or entity;
- unique nature, design, size, location etc.

Reason for change:

- Introduction of 'Fair Value' within IFRS:
  - Required for publicly quoted companies;
  - Fair value is not market value;
  - Fair value represents service potential;
  - Fair value should be market based;
  - IASB requires Fair value for specialised assets.

Reason for change:

- Need for consistency – public sector:
  - Survey revealed inconsistency of use;
  - Inconsistency of costings to public sector entity;
  - Resulting in potential loss of public services.

DRC:

- Is not an "exit value";
- Represents deprival value;
- Used other methods cannot be applied;
- Used where costs have no value in market.

DRC – Method:

- **Principles** are well understood; *the current cost of reproduction or replacement less deductions for obsolescence and optimisation.*
- **Application** has lacked consistency – limited guidance in RICS's Red Book;

FIG Munich 2006 Professor Frances Plimmer KINGSTON UNIVERSITY 7/21

Valuing the Land:

- Using market principles;
- Land used assumes replacement asset;
- Surplus land valued to market value;
- Assume permission for actual use; or
- Assume prevailing uses –a notional site.

FIG Munich 2006 Professor Frances Plimmer KINGSTON UNIVERSITY 8/21

Replacement Cost of Buildings:

- Estimate the cost of replacing buildings;
- Assume a modern substitute;
- Quality appropriate to location and client;
- The issue of protection – not relevant;
- Generic - standard building cost data;
- Recent constructions, use actual costs.

FIG Munich 2006 Professor Frances Plimmer KINGSTON UNIVERSITY 9/21

Replacement Cost of Buildings:

- Restrict fees to costs of procurement;
- Allow VAT only when not recoverable;
- No allowance for developer's profit;
- Componentisation not normally adopted.

FIG Munich 2006 Professor Frances Plimmer KINGSTON UNIVERSITY 10/21

Adjusting Gross Replacement Costs:

- To reflect any depreciation;
- Depreciation cured by capital investment;
- Depreciation assessed by market knowledge;
- Service life fixed in discussion with client.

FIG Munich 2006 Professor Frances Plimmer KINGSTON UNIVERSITY 11/21

Adjusting Gross Replacement Costs:

- Adjust costs using a systematic and consistent basis;
- Adjustment to the costs:
  - Consult with client;
  - Consider possible approaches; and
  - Nature of the asset.

FIG Munich 2006 Professor Frances Plimmer KINGSTON UNIVERSITY 12/21

Consultation with Client:

- DRC relies on data supplied by client;
- An active dialogue with client;
- Advise client on impact of:
  - policy changes;
  - assumption of a notional site.

FIG Munich 2006 Professor Frances Plimmer KINGSTON UNIVERSITY 13/21

Conclusions:

- Guidance is in response to:
  - Changes in accounting standards;
  - Inconsistency in practice;
- Guidance is aimed at:
  - Better client understanding;
  - Year-on-year consistency in approach;
  - Transparency;
  - Reducing inconsistency on change of appraiser.

FIG Munich 2006 Professor Frances Plimmer KINGSTON UNIVERSITY 14/21

Conclusions:

- Flexibility e.g. notional site;
- Alternatives and recommendations;
- Market provides some information;
- Methodology should be defensible and appropriate to needs of client.

FIG Munich 2006 Professor Frances Plimmer KINGSTON UNIVERSITY 15/21