

## Issues Paper

### Definition and application of residual value

#### Purpose

- 1 The purpose of this paper is to consider a request to clarify the definition of residual value in AASB 116 *Property, Plant and Equipment*.

#### Paper structure

- 2 This paper is organised as follows:
  - (a) Summary of submission received;
  - (b) AASB staff analysis of the issue;
    - (i) Residual value;
    - (ii) Residual value for recyclable assets;
    - (iii) Useful life; and
    - (iv) Componentisation;
  - (c) Preliminary AASB staff research;
  - (d) AASB options for addressing the issue; and
  - (e) AASB staff recommendation.

#### Summary of submission received

- 3 The submission (Agenda Paper 17.3) outlines an issue relating to not-for-profit (specifically local government) entities interpreting the AASB 116 definition of 'residual value' as requiring a cash receipt of the proceeds of sale (or deduction from a cash payment made for the acquisition of the replacement asset as with an item traded-on). The submission:
  - (a) argues that this interpretation of AASB 116 is unduly limiting and does not reflect the intention of AASB 116. The submission asserts that the definition of residual value in paragraph 6 of AASB 116 may unduly limit its recognition to circumstances in which an entity would receive proceeds from the sale of the asset;
  - (b) provides an example of an entity recycling crushed gravel for reuse in the reconstruction of a road to bring it back to a state that is identical to its original wearing surface. It is argued that the residual value of the original road surface, which is at the end of its useful life, is the 'cost savings realised (or expected to be realised) from the reuse of salvaged materials'; and
  - (c) recommends the Board consider including an 'Aus' paragraph in AASB 116 to permit not-for-profit entities to recognise the cost savings in replacing an asset as part of the residual value.

### AASB staff analysis

- 4 AASB staff note that, although the submission focusses on the narrow issue of definition of residual value in the context of not-for-profit entities, the issue raised has broader application in relation to the recognition and measurement of property, plant and equipment more generally. That is, the issue is not limited to the definition and application of residual value, but can also be analysed from a number of perspectives, including consideration of the following issues:
- (a) What does the term 'disposal' mean in relation to residual value?
  - (b) What is the residual value for assets intended to be recycled?
  - (c) What is the useful life for recyclable assets?
  - (d) How should recyclable assets be componentised for the purposes of applying AASB 116?
- 5 Further, AASB staff consider that the issues raised, although prevalent for not-for-profit entities, may also arise for for-profit entities that reuse and/or recycle assets. The following analysis reflects this broader application of the issue raised by the submitter.

### *Meaning of the term 'disposal' in the definition of residual value*

- 6 The term 'disposal' is not defined in Australian Accounting Standards. However, the common definition of the term is 'the act or means of getting rid of something'<sup>1</sup>.
- 7 The term 'disposal' is, however, used throughout Australian Accounting Standards. For example, AASB 116 paragraph 67 requires that the carrying amount of an item of property, plant and equipment be derecognised:
- (a) on *disposal*; or
  - (b) when no future economic benefits are expected from its use or disposal.

AASB 5 defines a 'disposal group' as being 'a group of assets to be *disposed of*, by sale or otherwise...' (Appendix A). [emphasis added]

- 8 In the definition of residual value, and its use throughout Australian Accounting Standards, the requirement for disposal appears to limit the recognition of a residual value to circumstances when an entity relinquishes control of the asset to a third party. For example, paragraph 69 of AASB 116 provides examples of disposal, being by sale, by entering into a finance lease or by donation.

### *Residual value for recyclable assets*

- 9 Given the definition of residual value in AASB 116, some AASB staff consider that assets intended to be recycled by an entity have a residual value of nil as the entity will not relinquish control of the asset by way of sale or donation to an external party.
- 10 Accordingly, some AASB staff consider the facts in the main example provided in the submission would lead to the entity recognising a residual value of nil.

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1 Oxford Dictionaries: <http://www.oxforddictionaries.com/definition/english/disposal> (accessed 14 August 2014)

- 11 These AASB staff also consider that it might be appropriate to more thoroughly consider the useful life of the recyclable asset in question.
- 12 Other AASB staff think the meaning of disposal is potentially unclear within the Standard and do not necessarily consider that an intended sale is required for an asset to have a residual value.

***Useful life of recyclable assets***

- 13 Useful life is defined in paragraph 6 of AASB 116 as ‘the period over which an asset is expected to be available for use *by an entity...*’ [emphasis added]
- 14 AASB 116 paragraph 57 clarifies that:

...the asset management policy of the entity may involve the disposal of assets after a specified time or after consumption of a specified proportion of the future economic benefits embodied in the asset. Therefore, the useful life of an asset may be shorter than its economic life. The estimation of the useful life of the asset is a matter of judgement based on the experience of the entity with similar assets.

- 15 The fact pattern of the key example in the submission notes:

The wearing surface is now in poor condition, has reached the end of its useful life and the road will be re-surfaced... In the process of reconstructing the wearing surface, the remnant sheeting from the original construction was graded up and mixed with additional gravel from the nearby pit, and graded, compacted and rolled as in the original construction.

- 16 Some AASB staff consider that the submitter is interpreting the useful life of the asset as being limited to its service life as opposed to the useful life of the gravel (service life and post service life up until the date at which the gravel is ‘capable’ of being recycled and incorporated in a new surface).
- 17 These AASB staff are of the view that as the definition of useful life of an asset is entity specific, to the extent that an entity expects to continue to use the asset – albeit in a repurposed way to the original use of the asset – the asset has a remaining useful life for the entity. Accordingly, these staff are of the view that the useful life of the gravel could extend beyond the time of re-surfacing of the road.

***Componentisation***

- 18 AASB 116 specifies that some items of property, plant and equipment may contain separate parts (paragraph 13) and those parts should be depreciated separately (paragraph 43).
- 19 In the road construction industry, staff have noted examples in practice where entities have componentised parts of a road in order to depreciate those parts separately. A common example is a road consisting of a base and a sub-base, where the base has a shorter useful life than the sub-base. At the end of the base’s useful life, the base has no residual value and is replaced with new materials.

***Preliminary AASB staff research***

- 20 Preliminary AASB staff research has identified that the issue raised by the submitter is common in the not-for-profit sector. However, AASB staff consider the fact pattern could

also be evident in the private sector. For example, mining companies building roads made of crushed gravel on private land to allow for the transport of materials could recycle gravel in order to bring the road back to its original wearing surface condition.

- 21 Accordingly, although more prevalent in the not-for-profit sector, AASB staff do not consider the issue to be not-for-profit specific.
- 22 Some examples from practice, identified by AASB staff, are provided in the Appendix to this paper. These limited examples indicate that many entities are recognising residual values above nil for recyclable road assets (Examples 1-4). Furthermore, some entities are recognising a useful life limited to the date of the recycling of the asset (Examples 2 and 4).

#### **AASB options for addressing the issue**

- 23 If the issue is not considered to be not-for-profit entity specific, the AASB Interpretations and Improvements Model<sup>2</sup> provides two options for addressing the issue:
  - (a) take no action and give reasons; or
  - (b) refer the issue to the IFRS Interpretations Committee for consideration.
- 24 If the issue is considered to be not-for-profit entity specific, the AASB Interpretations and Improvements Model provides two options for addressing the issue:
  - (a) take no action and give reasons; or
  - (b) add the issue to the work program and, if required, establish an Advisory Panel to prepare alternative views and recommendations for consideration by the AASB.

#### **AASB staff recommendation**

- 25 AASB staff consider that the issue is not limited to roads, but is also equally applicable to any recyclable asset. Preliminary analysis by AASB staff indicates that this issue is likely to be prevalent in the not-for-profit sector, and may also exist in the for-profit sector.
- 26 AASB staff recommend that staff undertake targeted outreach to constituents to further understand:
  - (a) the predominant approach to the accounting for recyclable assets in practice; and
  - (b) whether any diversity in practice exists.
- 27 Following this outreach staff will bring the results and further analysis to the Board at a future meeting.

#### **Question for the Board**

Does the Board agree with the staff recommendation in paragraph 26 above?

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2 [http://www.aasb.gov.au/admin/file/content102/c3/AASB\\_Interpretations\\_and\\_Improvements\\_Model\\_Feb\\_2012.pdf](http://www.aasb.gov.au/admin/file/content102/c3/AASB_Interpretations_and_Improvements_Model_Feb_2012.pdf)

## Appendix

### Example 1 – Cost savings through recycling crushed rock recognised as the Residual Value

The following diagram depicts the depreciation of various components of a sealed road asset over the life cycle of the pavement. In the example the total cost of acquisition was \$18 per square metre. The road seals cost \$2 per square metre and are expected to be replaced every 15 years. There is no residual value allowed for seals. The pavement component cost \$12 per square metre and is expected to be replaced after 60 years. The estimated cost to renew the pavement by recycling the crushed rock pavement materials is \$8 per square metre. The residual value is estimated at \$4 (\$12-\$8) per square metre. The road formation costs are not expected to be incurred again and therefore no depreciation is charged. Straight-line allocation of the depreciable amounts has been determined to best match the consumption of economic benefits.

### Example 2 - Cost savings through recycling materials recognised as an 'implied' Residual Value

#### **8.3 Residual Values**

Residual Value is the estimated amount that an entity would currently obtain from disposal of the asset, after deducting the estimated costs of disposal, if the asset were already of the age and in the condition expected at the end of its useful life.

With many infrastructure assets, however, the situation is more complex. For example, when a road is at the end of its useful life and designated for reconstruction, there is no resale value in the former construction material. Nevertheless, a road renewal treatment, for example a pavement reconstruction, is cheaper than constructing an equivalent pavement from scratch, because, for example, materials can be re-used. Thus the asset (in this case the old pavement) has an implied residual value. (This is illustrated in Figure 1.)

### Example 3 – Residual Value based on the ability to re-use/leave pavement material

The residual value on roads and footpaths as per the definition of residual value will not materialise on sale of the asset. The residual value for the pavement of footpaths and roads is based on the ability to re-use/leave the pavement material untouched when major renewal work is done to the asset. The calculation of the residual value is based on using the brownfield unit rates for the replacement of the untouched portion. We are currently in the process of recalculating brownfield unit rates for roads in accordance with our rolling program and will re-evaluate the residual value as part of this process.

### Example 4 – Cost savings through re-use of in situ materials (recycling) as the Residual Value

Total Useful life = (Date of Renewal – Date of Construction or Last Renewal). Validation of Useful life Essential for Any Depreciation Method. Total Useful life is the actual life achieved at renewal or total failure. It is not the design life or theoretical optimum renewal life. Useful life is determined by Council, taking into account other priorities, risk, cost and service level implications.

Asset Residual = Greenfield Replacement Cost – Actual Treatment Cost. The reduced cost of treatment reflects the re use of in situ materials that have a residual value. This also may include earthworks / formation that will be re used as part of the asset renewal.