

## **Residual Value of Recyclable Assets**

### **Additional Submissions – cover note**

#### **Purpose of this Agenda Paper**

- 1 The purpose of this agenda paper is to provide the additional submissions received from targeted outreach in relation to the application of residual value in AASB 116 *Property, Plant and Equipment*.

#### **Additional submission 1**

- 2 The first additional submission provides further information from the original submitter (OS).

#### **Additional submission 2**

- 3 The second submission was received in November 2014, which was combined with a number of miscellaneous fair value issues. At the time of receiving the submission, staff were not aware this was a formal submission and therefore it was not included in the December 2014 Board papers (AASB meeting M142).
- 4 While staff consider the submission, consistent with discussions held with the respondent in October 2014, is incorporated in View 2 in Agenda Paper 8.2, the respondent has informed staff he would like the original submission to be incorporated into this tabled paper. Accordingly, the pages in that submission that set out the respondent's views on residual value are incorporated in this agenda paper.

#### **Additional submission 3**

- 5 In addition to the views expressed by the respondent in additional submission 2 above, the respondent has provided a further submission noting concerns in relation to the staff recommendation in Agenda Paper 8.2.
- 6 AASB staff have considered the views of the respondent in tabled Agenda Paper 8.4. Staff consider this additional submission highlights the diverse interpretations of the requirements of AASB 116 and other related pronouncements. Staff consider the differing interpretations of such pronouncements provides further impetus for a staff article on the issue, as recommended to the Board in Agenda Paper 8.2.
- 7 In relation to the submitter's assertion that "the advice provided [by AASB staff on the issue] in previous years has been entirely consistent with View Two", staff are not aware of any such views being provided to the respondent. To the contrary, staff have identified previous correspondence with the respondent that they consider to be consistent with View 1 in Agenda Paper 8.2.

## **Summary of additional feedback received from the original submitter (OS)**

AASB staff received further feedback from the original submitter on the accounting for open surface roads. The respondent considers the road in the original submission has been adequately componentised into parts (i.e. drainage, formations and wearing surface). In respect of the submission supporting View 1, the original submitter considers it would be inappropriate to componentise the wearing surface (the gravel) further as the recyclable and non-recyclable components are physically indistinct. Accordingly, the original submitter disagrees with View 1, in particular the graph provided in paragraph 16 of Agenda Paper 8.2.

The original submitter considers the issue is further confounded when any such component is fair valued. Currently, many local councils are required to fair value infrastructure assets periodically, for example every five years. The respondent argues that accurately fair valuing sub-components of a road's wearing surface is not achievable. This is because the recyclable and non-recyclable components are indistinguishable.

Consistent with previous outreach, the respondent considers the issue is confined to a limited range of road infrastructure assets in the public sector, as in the private sector, for example mining companies, any such recyclable component of a road will likely be immaterial.

# Miscellaneous Fair Value Issues

For input to AASB Outreach Project

(Nov 2014)

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reliance can be placed on the assumption. If there is high confidence in the assumption the sensitivity analysis should report a low range of variation (say +/- 2.5%) whereas low confidence should translate into a much high range of variation (says +/- 30%).

For example – if an entity had its assets valued off a spreadsheet with no validation of the underlying assumptions or inspection of the assets there would be concerns over the completeness, accuracy and existence of the assets as well as the valuation methodology. As a result we would expect the sensitivity of the fair value measurement to be much higher than if the assets were physically inspected and validated.

### Model statements reinforcing non-compliance

As noted above many entities have either been instructed by regulators, industry groups or even auditors to duplicate the example disclosures in the model statements. However as the quality of some of these is questionable and do not necessarily comply with the requirements the entities have been thrust into a position where their work has become more complex and difficult than it should be.

In reality each entity will adopt slightly different approaches and assumptions to similar asset classes and as a consequence the disclosures for each entity need to be tailored to meet their specific scenario.

Model statements are only models and should not be used as a set template. However in practice the wording and formatting set out in model statements are typically used as the benchmark and any variation from that is not well received by some auditors.

It is unfortunate that many of the model statements include a range of practices and disclosures that are not necessarily consistent with all aspects of the accounting standards and as a consequence continue to reinforce outdated practices which are no longer consistent with the current accounting standards.

### *Definition of Residual Value*

The paper submitted to the Board highlight the different approaches applied to the definition of residual value. The issue is based upon different approaches when applied to assets subject to cyclical maintenance. I also think that as part of this issue due cognizance needs to be given to the concept of 'useful life' as both go hand in hand. Residual Value is defined in terms of a value at the end of the 'useful life' and therefore any discussion on the subject needs to consider these two concepts in combination with each other. Just as there are different interpretations of Residual Value there are also different views on "Useful Life".

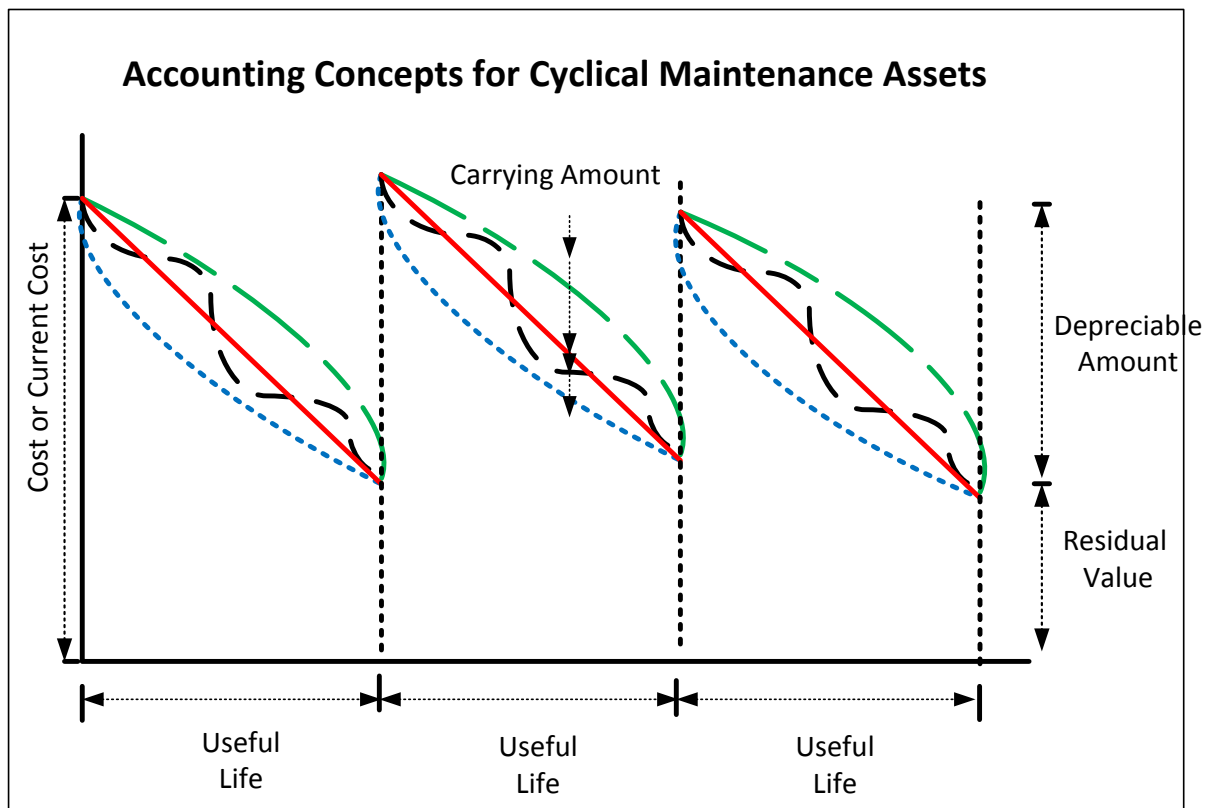
Essentially the issue relates to assets which are subject to continuous renewal. While the AASB papers referred to them as 'recycling' I think the more appropriate term is 'cyclical maintenance' assets which was previously defined in Australian Interpretation 1030. While

some assets may be renewed through use of recycled material there are also other approaches used to renew the asset. Through 'cyclical maintenance' assets are continually renewed resulting in the overall asset continuously extending its useful life.

As noted in the paper submitted to the AASB some interpret the residual value as being a cash inflow received upon ultimate sale of the asset (scrap or salvage value) whereas others consider it to be the amount of cost saving achieved through renewing the component.

I agree with the general thrust of the paper submitted to the AASB. Furthermore I argue that it is totally inappropriate to base the residual value (in the case of assets subject to cyclical maintenance) on a theoretical scrap or salvage value upon the ultimate disposal. This approach does not take account of the asset management reality and also results in material misstatement of the real Fair Value. Additionally the assumptions have extremely low levels of reliance due to the inability of anyone to predict such a useful life. The CPA Australia guide incorporates an example to demonstrate the errors that result from such an approach.

For assets subject to cyclical maintenance we believe that the renewal of a component represents the disposal of the old component and creation of a new component. As a result the Residual Value should represent the amount of value that flows from the pre-renewal component (which is now disposed) to create the post-renewal component. In simple terms – if you spend \$40 to end up with an asset worth \$100 then there must have been \$60 of value transferred from the disposed component into the new component. In the CPA Australia guide the concepts underpinning AASB116 are represented as follows. These concepts have also previously been described in the IPWEA Australian Infrastructure Financial Management Guidelines (2009).



Based on this we would argue that the existing standard's definition already provides for both approaches as the definition refers to 'an amount'. We argue that 'an amount' could be either a cash inflow from a sales proceed or a cost saving achieved by recognizing the transfer of service potential from one asset into the new asset.

We also believe that accounting standards should always be interpreted taking into account the application of 'substance over form'. In this case, if an asset is renewed back to 'as new' through some form of cyclical maintenance then the appropriate accounting result should be to capitalize the cost of the work and the total value should then be equal to an 'as new' asset. In order to achieve this the 'residual value' should approximate the difference between these two figures at the expected time of intervention.

If the AASB were to incorporate an AUS paragraph we suggest that the paragraph highlight that the amount may represent either a cash inflow from sale or a cost saving achieved from asset renewal.

6 Feb 2015

## Response to AASB Staff Paper Residual Values

I would like to submit this letter for consideration at the AASB Board meeting being held on Monday 9 Feb 2015 regarding the staff paper prepared on the topic of Residual Value.

**I wish to note my extreme disagreement with the conclusions reached in this paper.** I believe the analysis fails to understand the realities of how assets are actually managed in the public sector and that the recommended approach is technically flawed.

**I also wish to highlight that a formal submission was prepared by myself following a discussion between myself and Dr Mark Shying (formally of CPA Australia). I note that this proposal was submitted to the AASB via email on 24 November but has been excluded from the official board papers under section 8.2. I have attached this paper for board consideration.**

The board paper provides for two views. However view one (which is recommended by the staff paper) is fundamentally flawed. **I would argue that view one is in effect consistent with view two but uses incorrect terminology in order to achieve the same result.** This terminology has then been in-accurately adopted with the AASB staff paper. **As a consequence view one, if adopted, will result in entities manipulating the underlying assumptions in order to achieve results which may not necessarily reflect the reality.**

**Accordingly I believe the AASB should not accept the recommendation of the staff paper but should direct the staff to take further detailed analysis.**

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View One argues that an asset component should be further componentised into two sub-components (recyclable and long-life component). It then proposes that the part subject to renewal be depreciated to nil (zero residual value) over the appropriate renewal period and for the long-life component to be depreciated using a straight-line over the remaining useful life.

This process is shown in the diagram below. The depreciation of the long-life component is to recognise that most assets will eventually become obsolete and decommissioned resulting in the need to depreciate the total value of the asset over an extended useful life. However view one is based on an assumption that all assets have a finite life and will become obsolete. This is in direct contradiction to AASB1051 which highlights that some assets (or components) such as road earthworks may have an indefinite life and therefore are not required to be depreciated.



This approach creates a huge problem regarding the valuation of long lived assets. The reality for assets such as roads, civil assets and even buildings (especially heritage listed) is that the various components will be renewed through on-going cyclical maintenance. The impact of this maintenance is to restore previously consumed service potential and effectively create a new 'useful life'. As a result it is impossible to accurately predict the final end of life assumption which would be needed to determine the period over which the 'long-life' component should be depreciated.

Furthermore a condition assessment of a road pavement (even after 5 reseals over the top) may indicate that the service potential embodied within the pavement is still very good. Providing the road is not considered obsolete it would therefore be appropriate to value the pavement based on the condition = high value. However under view one the valuer needs to estimate a theoretical end of life (which cannot be supported by any evidence) and then write the pavement down to a low value. We then have a bizarre situation of an asset with very level of remaining service potential being valued as if it is at the end of its life.

Such an approach would be in direct contradiction of AASB13 which requires the valuer to take into account condition and comparability.



This approach (especially when taken into account with paragraph 33) would encourage entities to adopt totally theoretical useful life assumptions (such as the life of the long-life component being in excess of 1,000 years) which in turn can be used to manipulate the results. Such assumptions are nothing more than guesses and are unable to be supported by sufficient and appropriate audit evidence.

There is a further issue in that there may only be one physical component. View one takes the view that a component can be split into multiple components (short-life and long-life). This firstly is not physically possible and even from a theoretical perspective the split would then need to be made based on the most likely future asset management treatment.

For example a road seal might be comprised on a 3 coat seal. In reality – there is only one component – a seal. Assume gross cost of \$12. If the proposed asset management treatment is to do a one coat reseal in year 9 at a cost of \$4 View One would argue that the short-life component = \$4 and the long-life component = \$8. However after a few years the entity might decide to change its strategy resulting in a plan to do a 2 coat seal in year 12 rather than the previous strategy. It is important to remember that there is only one seal. Under View One this change in strategy would then mean the cost of the short-life component = \$8 and the long-life component = \$4. Clearly this creates significant challenges for the asset register and will cause inconsistency between the financial asset register (two components) and the asset management system (one component).

Essentially the difference between View One and View Two was discussed at the 2014 NSW Local Government Auditors Association. This highlighted that View One is really nothing more than a bastardised version of view two where the terminology used is not consistent with the terminology per the accounting standards.

Under view one the 'long-life' component is in effect the non-depreciable part of the component and therefore by definition is the Residual Value (per AASB116). Where the asset is not considered to be obsolete, this part of the component has an indefinite life and therefore should not be depreciated. Only once there are indicators of this part having a finite life should it be depreciated.

View Two recognises that depending on the asset management strategies adopted by the entity the cost, effect and timing of the future renewal will change. In accordance with AASB116 this is recognised by the need to review at least at the end of each year the useful life, residual value, pattern of consumption as well whether there are any indicators of changes in value due to the changing value of money, condition or impairment events.

View Two breaks the asset down into the various components that exhibit different useful life or patterns of consumption. These are usually closely aligned to the same components used for asset management planning. The real difference between View One and View Two however is that View Two takes into account the future asset management strategy and based on that adjusts the split between depreciable amount and non-depreciable amount (residual value). As an entity changes its asset management strategies this will then translate into changes in the underlying assumptions.

For example an entity might plan to replace underground pipes with new pipes. Accordingly the residual value would be nil. However if they changed their strategy to use re-lining there will be an impact on their future budgets. Effectively re-lining enables the service potential of pipes to be restored back to 'as new' for only 50% of the cost of laying new pipe. In this situation View Two would assign a Residual Value of 50% and the 50% renewal cost would be depreciated over the time between the intervention points.

Under View One however we would create a fictional component called 'long-life' component equal to 50% and then we would depreciate the recycled-component (50%) over the time between intervention.

In effect we get the exact same result. However the terminology used under View One is incorrect.

Based on the View One approach the Residual Value would always equal nil. This appears to be in conflict with AASB116 which requires an annual review of useful life, residual value and pattern of consumption. This begs the question – if the Residual Value is always nil then why do we need to do an annual assessment?

In short – View One's terminology is inconsistent with AASB116. However both approaches are effectively trying to achieve the same result. The risk with View One is that it will be incorrectly adopted and will result in material misstatement.

I also wish the Board to note that over the past eight years I have from time to time held detailed discussions with a range of the AASB technical staff regarding asset issues. This included discussions for the development of the CPA Australia guides to valuation and depreciation of public and NFP sector assets as well as the IPWEA Australian Infrastructure Financial Management Guidelines. While I acknowledge that the views of the staff are only that and cannot be relied upon I wish to highlight that the advice provided in previous years has been entirely consistent with View Two.

**Before making a decision regarding the recommendations included in the staff paper I urge the Board to require the staff to undertake further**

analysis and for that to include working through a range of alternative scenarios.

Yours faithfully  
**APV Valuers and Asset Management**



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