TAD_RV_sub_1_APV

Valuers & Asset Management

AASB Meeting 15 April 2015
Agenda Paper A4 (M144)

Submission

AASB Tentative Agenda Decision: Residual Value

David Edgerton FCPA
Director
david@apv.net

(Head Office)
Queensland
Level 18
344 Queen Street
Brisbane QLD 4000
p (07) 3221 3499
f (07) 3221 8409

New South Wales
Goldfields House
Suite 3 Level 21
1 Alfred Street
Sydney NSW 2000
p (02) 8231 6499
f (07) 3221 8409

South Australia
Level 3
97 Pirie Street
Adelaide SA 5000
p (08) 8311 3949
f (07) 3221 8409

Western Australia
Suite 83
50 St Georges Terrace
Perth WA 6000
p (08) 6323 2338
f (07) 3221 8409

www.apv.net

Table of contents

About APV





What we do

APV provides specialist valuation, asset management and asset accounting services for a wide range of organisations and sectors. We enjoy close partnerships with our clients across Australia, including hundreds of local councils, state government agencies, manufacturing and transportation businesses, universities and not-for-profit organisations.

Our services include:

- Fair Value valuations: land, buildings, plant, equipment, roads, water, sewerage
- Asset accounting: valuation and depreciation methodologies, compliance reviews
- Asset management: asset management frameworks, plans and systems
- Customised training and professional development: asset accounting and asset management.

As leaders in our field, we are proud of our unblemished record of audit approval. However, uncompromising quality is simply our starting point: *we deliver more than just figures*. We tailor our services to meet client needs, helping them get the most from their assets and plan effectively for the future.

And while valuation and depreciation can be complex, we keep it simple. We're constantly evolving to offer customers more flexibility and control. We use leading methodologies and custom-built valuation tools that are compliant, comprehensive, logical and truly relevant.

Introduction

The AASB issued a Tentative Agenda Decision regarding Residual Value following their Feb 2015 meeting.

The decision has drawn significant response from a wide range of expert practitioners who believe that the board's tentative decision has been based on an extremely narrow interpretation of the standards and that given nuances of both the valuation and depreciation of public and Not-For-Profit (NFP) assets **there is room for a more broader interpretation. Such an interpretation could be validated by the inclusion of an AUS paragraph in AASB116.**

The board published the decision as a tentative decision has now sought responses from those who disagree with their tentative decision.

The AASB alert regarding the tentative decision advised -

> *This tentative agenda decision, including proposed reasons for not adding the items to the Board's work program, is expected to be reconsidered at the Board meeting in May 2015. Constituents who disagree with the proposed reasons, or believe that the explanations may contribute to divergent practices, are encouraged to comment to the AASB by email to standard@aasb.gov.au by 20th April 2015.*

This paper highlights that the paper only deals with the interpretation of Residual Value. The tentative decision does not provide any specific guidance on –

- **the determination of Fair Value or**
- **the methods used to calculate Depreciation Expense (other to highlight that the method used shall depreciate the depreciable amount over the useful life using a method that matches the expected pattern of consumption of the future economic benefits).**

This paper highlights that the range of divergent practices evolved based on determining the timing, impact and cost of those asset management treatments to enable a more accurate estimate of the level of future economic benefit consumed from year to year (pattern of consumption). In the public sector it was recognized that due to the regular renewal there was a part of the value of the asset that was preserved (not consumed) between intervention points. This has been identified by the AASB as the long-life component. However due to limitations in existing accounting systems this required a manual work around.

The work around was achieved by the entities **recording the estimated value remaining in the asset at the time of intervention as the Residual Value in the various accounting and asset management system**. This achieved a pragmatic approach to providing the best estimate of the amount of value to be consumed between the periods of last renewal and the next renewal.

As a result it is recommended that any staff papers prepared as a consequence of the decision note that it –

- **deals only with the question asked: the determination of Residual Value**
- **provides no specific guidance on determining the expected pattern of consumption of the economic benefits**
- **as such it provides no specific guidance on acceptable or unacceptable approaches to determining depreciation expense**
- **both View One and View Two should provide similar results providing there is adequate componentisation**
- **To determine depreciation expense (for assets which are subject to regular renewal) entities need to consider the most likely asset management treatments that will be applied to undertake future renewal of the existing assets**
- **Based on that, in order to determine depreciation expense, they must apply a method that matches the expected pattern of consumption of the future economic benefit. This might be achieved by -**
    - **Creating separate components for the short-life part and the long-life part and depreciate accordingly; or**
    - **Adopting other approaches that they consider will provide a better estimate of the expected pattern of consumption of the future economic benefits.**
- **All assumptions used should be supported where possible by sufficient and appropriate audit evidence or sound argument.**
- **The diagram shown as View One be enhanced to indicate that the pattern of consumption of future economic benefit may variable.**

David Edgerton FCPA

1 April 2015

Director
APV Valuers and Asset Management
E: David@apv.net
Mob: 0412 033 845

Background

In October 2014 a paper was submitted to the AASB questioning whether the definition of Residual Value needed to be enhanced. The argument put forward was that there were a range of practices adopted across all jurisdictions and that these practices were well accepted. It also highlighted some inconsistency of different approaches used to determine the Residual Value.

Some practitioners argue that the Residual Value must be a cash inflow whereas others argue that when an asset is renewed the existing asset is disposed and is effectively replaced with a new asset. Accordingly they argued that the value that transferred from the disposed asset into the new asset (with new useful life) represented a cost saving and could be interpreted as the Residual Value.

Another way of looking at the issue was that the Depreciable Amount represented the value that would be lost over the life of the asset. **i.e. The Residual Value represented the value that would not be lost. As a result Depreciable Amount (using an asset management approach) could be interpreted as the total value lost between the intervention points when assets were renewed and the useful life re-set.**

The AASB issued a tentative decision on 23 Feb 2015 which stated –

- There were two common views of Residual Value
  - View 1: residual value is only recognised in circumstances when an entity expects to receive consideration for an asset that is at the end of its useful life and, accordingly, would not include the cost savings from the re-use of in-situ materials; and
  - View 2: residual value includes the cost savings from the re-use of in-situ materials.

- If significant values attach to in-situ materials, and they are expected to be recycled, the materials have not reached the end of their useful lives. Accordingly, the AASB considered that a residual value would only be recognised when an entity expects to receive consideration for an asset at the end of its useful life.

- Adequate componentisation of parts of an item of property, plant and equipment, and appropriate estimation of useful lives of such parts, would result in a similar overall depreciation expense recognised under either View 1 or View 2.

- On the basis of the analysis performed and in light of the existing requirements in Australian Accounting Standards, the AASB determined that neither an Interpretation nor an amendment to a Standard was necessary. Consequently, the AASB [decided] not to add this issue to its work program.

Scope of the Decision

It is important to note that the original paper submitted to the board and the decision flowing from the October 2014 meeting was specifically related to the **determination of Residual Value**. Likewise the tentative agenda decision from the Feb 2015 meeting relates only to the determination of Residual Value.

It is critical to note that the tentative agenda decision and associated papers provide no guidance in relation to other key aspects of AASB116 as they relate to the determination of Depreciation Expense. Ie. **They do not include any discussion around the appropriateness of commonly adopted depreciation methods or deal with specific technical issues such as the expected pattern of consumption of the future economic benefit.**

Under AASB116 the purpose of determining the Residual Value is so that it can then be deducted from the value of the asset to determine the Depreciable Amount which in turn is to be depreciated over the useful life. The **objective is to determine the maximum proportion of the asset value that should be subjected to depreciation**. Based on the tentative agenda decision this would essentially equate to the complete value of the asset (unless there was some scrap value).

It is important to note that the accounting standards do not mandate the application of any particular depreciation method. Nor do they require that Residual Value necessarily needs to be included as a direct input to the algorithm used to calculate depreciation expense (such as when the output method is used). Instead AASB116 requires that when calculating depreciation expense the entity must ensure that –

- Assets are to be split into components which have a different useful life or pattern of consumption
- For each component –
    - Depreciate the depreciable amount
    - Over the useful life
    - Using a method that matches the expected pattern of consumption.

Accordingly it is important that the final decision and any educational papers provide appropriate recognition that the tentative decision relates only to the determination of Residual Value and has no direct impact on the determination of Fair Value or the method used to calculate Depreciation Expense.

Evolution of Alternative Practices

The original question raised with the board indicated common acceptance of the use of Residual Values for long lived assets subject to regular renewal. This then begs the question as to why such approaches have been accepted in the past and to some extent promoted by a range of publications including –

- Auditor-General's Reports to Parliament
- CPA Australia guidance
- IPWEA guidance

My initial reaction to the issue was that the View Two interpretation was justified if the board was willing to accept a broader interpretation than taken in the tentative decision. This is also supported to some extent by the board's statement that both approaches should result in similar results. However as the AASBs are based on the IFRS framework (which is based on private sector principles) such a broad interpretation is unlikely to ever be accepted.

Upon further reflection and discussion with a range of experts and clients I considered the evolution of these approaches. They resulted from the desire (and I would argue achievement thereof) to closer align asset accounting and asset management. I concluded that the **approaches used were designed to match the pattern of consumption and unfortunately the term Residual Value was adopted to assist in this endeavor purely for simplicity.**

Under these approaches the term 'Residual Value' was used as a simple means to describe the estimated value remaining (preserved) in the asset at the point of intervention. **The tentative agenda decision has in turn described this as the recyclable amount.**

The range of different approaches have evolved from common agreement across all professions that different asset management treatments taken at different stages of the asset lifecycle had an overall financial impact on the total cost to provide the services and maintain the service levels of the assets**. As such the overall 'loss of future economic benefit' through wear and tear and obsolescence was dependent on the impact and timing of the various asset management treatments employed to renew or relief the assets.**

In layman's terms, the impact of different asset management strategies would result in a shorter or longer useful life and therefore should result in different depreciation rates.

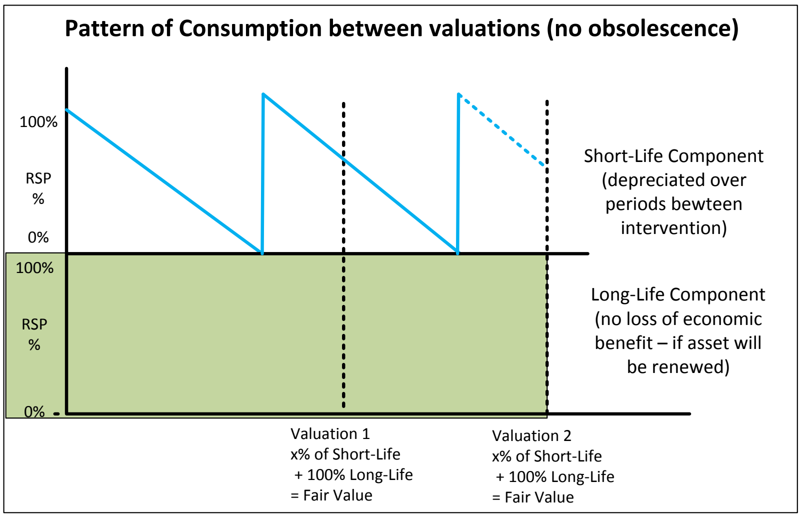
As a result a range of practices evolved based on determining the timing, impact and cost of those asset management treatments to enable a more accurate estimate of the level of future economic benefit consumed from year to year (pattern of consumption). With robust asset management the overall value of benefits provided by the assets should be extended over a longer period of time than if no or poor asset management practices were adopted. Accordingly the rate of consumption (depreciation) would alter over time based on the success of the asset management strategy.

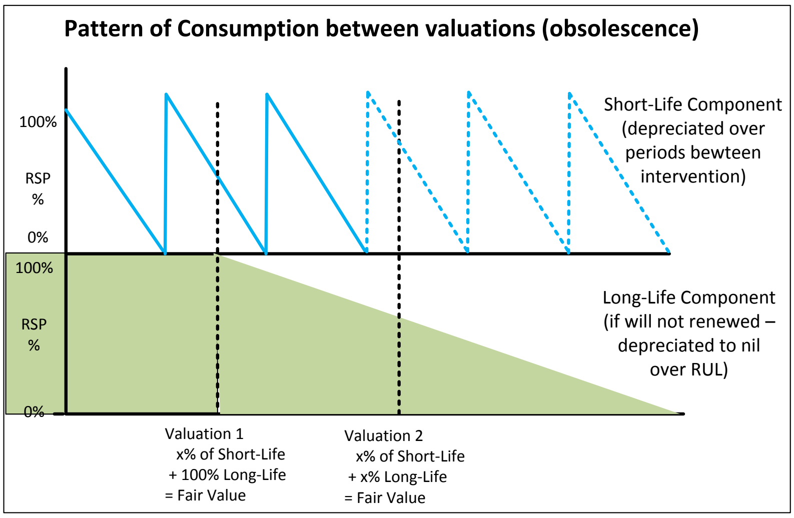
To simplify the approaches, and in many respects to fit the capabilities of existing financial accounting systems, the approaches substitute the useful life and the period between interventions (as per View One short-life component) and estimated value remaining in the asset at the time of intervention as an estimate of the Residual Value. **This achieved a pragmatic approach to providing the best estimate of the amount of value to be consumed between the periods of last renewal and the next renewal.**

The lesson from my reflection however was that –

- these approaches evolved to provide a better estimate of the expected pattern of consumption of the future economic benefit (i.e. they deal with paragraph 60 of AASB116).
- Residual Value was only used as a term to help explain how the different asset management treatments would result in a different loss of future economic benefit and to fit within the limitations of existing financial accounting systems.
- As the analysis of the asset management approaches identified the 'value lost' between interventions this represented the amount to be depreciated. The balance therefore represented a non-depreciable amount. This of course was considered consistent with the concept of Residual Value.
- Calling the expected value of the recyclable part at the time of intervention 'Residual Value' enabled existing financial accounting systems to deal with the calculations without requiring significant system redesign.

The following diagrams shows the value of the recyclable part being 'preserved' on the basis that while renewal is expected to occur there is no loss of future economic benefit of this part. However in cases where renewal is not expected to occur into the future the 'preserved value' is reduced to the Residual Value (nil).





As a result it is important to note that the tentative agenda decision –

- **deals only with the question asked: the determination of Residual Value**
- **provides no specific guidance on determining the expected pattern of consumption of the economic benefits**
- **as such it provides no specific guidance on acceptable or unacceptable approaches to determining depreciation expense**
- **both View One and View Two should provide similar results providing there is adequate componentisation**
- **To determine depreciation expense (for assets which are subject to regular renewal) entities need to consider the most likely asset management treatments that will be applied to undertake future renewal of the existing assets**
- **Based on that, in order to determine depreciation expense, they must apply a method that matches the expected pattern of consumption of the future economic benefit. This might be achieved by -**
    - **Creating separate components for the short-life part and the long-life part and depreciate accordingly; or**
    - **Adopting other approaches that they consider will provide a better estimate of the expected pattern of consumption of the future economic benefits.**
- **All assumptions used should be supported where possible by sufficient and appropriate audit evidence or sound argument.**

Pattern of Consumption

As stated previously, the scope of the AASB paper was limited purely to the determination of Residual Value. **It did not provide any guidance on the determination of Fair Value or Depreciation Expense**. AASB116 includes a range of requirements regarding the calculation of depreciation. The staff paper prepared for the board included reference to the Residual Value and the Useful life. However it did not include any analysis of the impact on depreciation as a consequence of the need for the depreciation approach to match the expected pattern of consumption of economic benefits.

Key paragraphs of AASB116 Property, Plant and Equipment include:

> *43 Each part of an item of Property, Plant and Equipment with a cost that is significant in relation to the total cost of the item shall be depreciated separately.*
>
> *50 The depreciable amount of an asset shall be allocated on a systematic basis over its useful life.*
>
> *51 The residual value and the useful life of an asset shall be reviewed at least at each financial year-end and, if expectations differ from previous estimates, the change(s) shall be accounted for as a change in an accounting estimate in accordance with AASB108 Accounting Policies, Changes in Accounting Estimates and Errors.*
>
> ***60 The depreciation method used shall reflect the pattern in which the asset's future economic benefits are expected to be consumed by the entity.***
>
> *61 The depreciation method applied to an asset shall be reviewed at least at each financial year-end and, if there has been a significant change in the expected pattern of consumption of the future economic benefits embodied in the asset, the method shall be changed to reflect the changed pattern. Such a change shall be accounted for as a change in an accounting estimate in accordance with the AASB108.*

Depreciation is understandably a complex issue and requires consideration of how each of the key inputs impact on the others. For example – Residual Value is defined in terms of the when you consider the asset to have reached the end of its useful life. Likewise the pattern of consumption will impact the assessment of how much and how soon the remaining service potential is consumed.

It should be noted that the Australian Accounting Standards have always required that the method of depreciation use a method that matches the pattern of consumption. However in the early days the then AAS4 Depreciation provided that it 'should' be used' but if it were too difficult or not possible to do so that the straight-line method could be used as a default because it was simple and easily understood. However this was changed in 1997 (18 years ago) and resulted in the removal of straight-line as a default and mandating that the method MUST match the pattern of consumption.

The pattern shown in the diagram for View One indicates a straight-line pattern with the long-life component being depreciated over a very long life. As stated previously the decision of the Feb 2015 meeting indicates that this estimated life might be longer than the operational life.

This example is however of course only one interpretation of what might occur in the future and based on a specific paradigm. It is the responsibility of the entity to determine the pattern of consumption based on the factors that drive its consumption and their experience with similar assets.

This might include assessing how much future economic benefit is lost via the adoption of different asset management strategies. This in turn should impact on the calculation of depreciation expense.

Many asset management practitioners and asset accountants recognize that the pattern of consumption of most long-lived assets is not constant (straight-line) and that it is constantly impacted by the success of the asset management framework, changes in asset management strategies, the impact of obsolescence, changes in technology and changes in community demands and expectations.

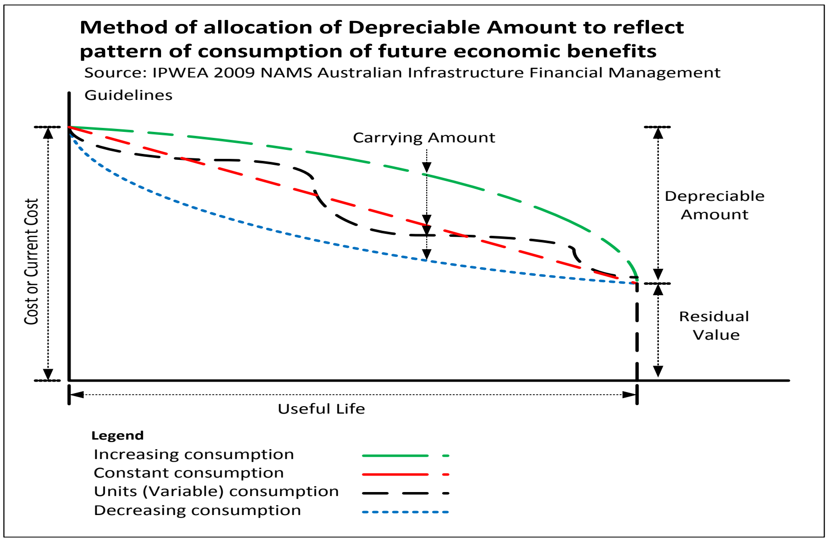
If the pattern did not change and remained constant then this would render the benefits obtained from improved asset management as a waste of time and resources. Clearly this is not the case. Changes in asset management practices and strategies result in changes in the rate of consumption of future economic benefit. In layman's terms this could be interpreted as changes in the Useful life or RUL. This is only one reason why entities need to undertake annual reviews of the useful life, residual value and pattern of consumption.

Additionally many asset management practitioners recognize that for long-lived assets it is impossible to even remotely predict the time to decommissioning (as used as the time of disposal under View One). For example – how do you accurately predict the useful life of a dam spillway? Is it 150 years or300 years The difference in these assumptions will result in a 100% difference in the amount of depreciation expense. Some might argue the life of a dam may even be in excess of 1,000 years.

Both the CPA Australia guide to valuation and depreciation of public and NFP sector assets (2013) and the IPWEA Australian Infrastructure Financial Management Guidelines (2009) as well as previous Best Practice Guidelines issued by the Queensland Audit Office (1999, 2000 & 2003) have recognized that the 'pattern of consumption' could either be –

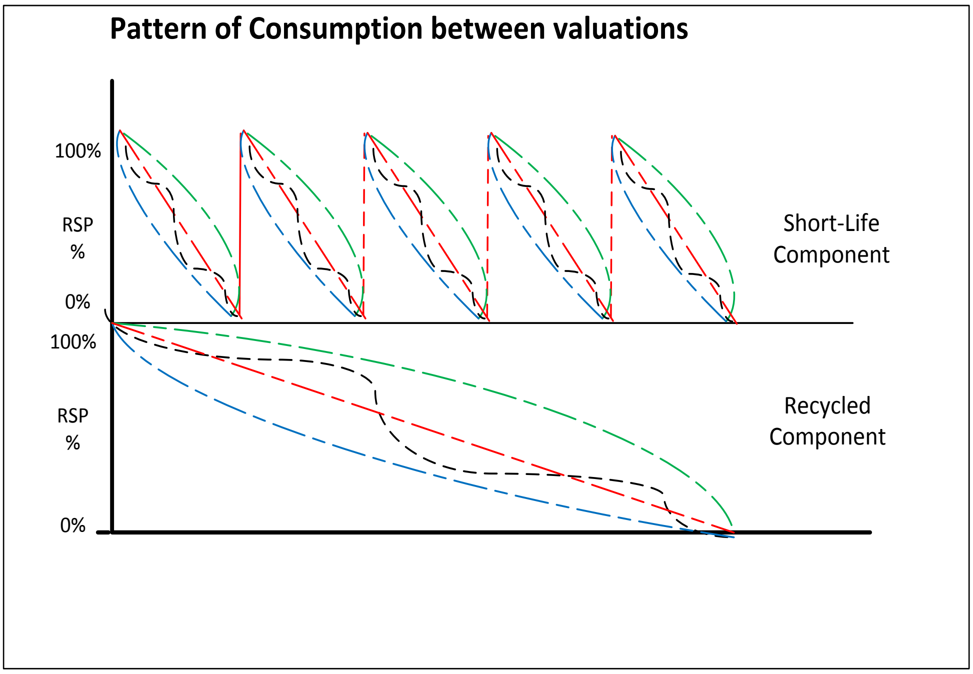
- constant
- increasing over time
- decreasing over time
- variable over time

This has been diagrammatically represented as follows –



AASB116 requires an annual review of the expected pattern of consumption. Accordingly we recommend that the board's decision reflect –

- **AASB116 requires an annual reassessment of the pattern of consumption**
- **It is the responsibility of the entity to determine the pattern of consumption for each component based on their understanding of how the assets behave the likely impact of future asset management strategies and the potential for legal and other obsolescence.**
- **That the pattern of consumption for each component may be different (as shown below).**



Conclusions and Recommendations

There are a number of potential implications flowing from whether an entity chooses to literally adopt View One as a method of depreciation or to continue to adopt existing depreciation methodologies which use an estimate of the recyclable value as in input to determining the expected pattern of consumption of the future economic benefit.

If a literal interpretation of View One is adopted most entities will need to significantly expand their asset registers to include a short-life and a long-life component for most existing components. This on turn will create significant complexities and associated costs and risks in trying to reconcile the asset management systems to the financial accounting systems.

The approach of estimating the value remaining in an asset at the expected time of renewal in order to better estimate the pattern of consumption has gained strong acceptance over the past twenty years. The key benefit of this approach is that by substituting this figure for the 'Residual Value' in accounting systems the entity is able to achieve the same outcome as View One without needing to invest significant resources, increase risk or implement significant changes to their financial systems. There is a strong belief that provides a more accurate measure of the depreciation expense as it provides closer alignment to the real pattern of consumption.

The board has already noted that both View One and View Two should achieve similar results provided there is adequate componentization.

Given this we believe there is sufficient scope within AASB116 to include an AUS paragraph which, for assets subject to regular renewal, to adopt the concepts described as View Two as an acceptable interpretation of Residual Value.

Even if the board is unwilling to adopt a broader interpretation it is recommended that any staff or educational paper note that -

- **The board's decision deals only with the question asked: the determination of Residual Value**
- **It provides no specific guidance on determining the expected pattern of consumption of the economic benefits**
- **As such it provides no specific guidance on acceptable or unacceptable approaches to determining depreciation expense**
- **Both View One and View Two should provide similar results providing there is adequate componentisation**
- **To determine depreciation expense (for assets which are subject to regular renewal) entities need to consider the most likely asset management treatments that will be applied to undertake future renewal of the existing assets**
- **Based on that, in order to determine depreciation expense, they must apply a method that matches the expected pattern of consumption of the future economic benefit. This might be achieved by -**
    - **Creating separate components for the short-life part and the long-life part and depreciate accordingly; or**
    - **Adopting other approaches that they consider will provide a better estimate of the expected pattern of consumption of the future economic benefits.**
- **All assumptions used should be supported where possible by sufficient and appropriate audit evidence or sound argument.**

About the Author

Mr David Edgerton
Director

Asset Accounting, Asset Management & Methodology.

Bachelor of Commerce

Fellow CPA Australia

David is an internationally recognised leader in asset accounting and asset management. He was named the 2001 National Public Sector CPA of the Year.

Before joining APV in 2006 David worked extensively in asset accounting and asset valuation across the public sector through his roles with the Queensland Audit Office (QAO).

He completed audits of state government departments, local governments, statutory bodies and corporations. He was chair of the Audit Office's Asset Valuation Audit Advisory Group and was a key contributor to its Better Practice Guides for Non-Current Assets.

Since the early 1990s, David has devoted significant time to corporate governance, asset accounting and asset management issues. This has included being:

- CPA Australia's representative on the Australian Asset Management Collaboration Group
- Author of CPA Australia's guides to the valuation and depreciation of public sector and NFP sector assets under the international accounting standards (2013) and Australian Accounting Standards (2015)
- Convener of CPA Australia's Infrastructure Assets Discussion Group and member of the Queensland Public Sector Committee
- Contributing author of the NAMS Australian Infrastructure Financial Management Guidelines
- Author and presenter of CPA Australia's Asset Accounting and Asset Management in the Public Sector program.

David's audit and accounting background is evident in APV's quality-control process and compliance record. He is also a highly sought-after presenter, has a flair for providing practical and innovate solutions to complex problems, and enjoys fostering co-operation across a broad range of stakeholders.

Contacts

Alfio Ponticello
Managing Director
alf@apv.net
(07) 3221 3499

David Edgerton
Director
david@apv.net
0412 633 845

BRISBANE (Head Office)
Level 18, 344 Queen Street
BRISBANE QLD 4000
(07) 3221 3499

SYDNEY
Level 2 50 York St
SYDNEY NSW 2000
(02) 8231 6499

ADELAIDE
97 Pirie St
ADELAIDE SA 5000
(08) 8311 3949

PERTH
Suite 83
50 St Georges Terrace
Perth WA 6000
(08) 6323 2338

ABN: 236 984 72195
Website: www.apv.net
Email: admin@apv.net

ACCOUNTING STANDARD AASB 116

DEFINITION OF

RESIDUAL VALUE

Further Submission by

DG & AB MAXWELL
Consulting Accountants

2 February 2015

DG & AB Maxwell
Consulting Accountants
PO Box 5450
Wagga Wagga NSW 2650

DEFINITION OF RESIDUAL VALUE

Further Submission

INTRODUCTION

This firm made a submission dated 2 June 2014 arguing that for certain not-for-profit entities (specifically for local governments) the definition of residual value should include, where an asset is replaced, cost savings arising from the salvage and re-use of materials in the construction of the replacement asset, net of costs of salvage.

The Board made a tentative agenda decision at its February 2015 meeting, "that neither an Interpretation nor an amendment to a Standard was necessary. Consequently, the AASB [decided] not to add this issue to its work program."

On 5 March 2015 we made a Supplementary Submission arguing that this decision should be further reviewed, on the grounds set out in that submission with arguments based on the specifics of the types of assets to which the original submission referred.

As a Chartered Accountant of long standing[1] the author has become concerned over a period of years that there is a developing tendency to ascribe greater depths of meaning to the wording contained in Accounting Standards beyond the intention of the standard-setters at the time of issue.

AASB 116 paragraph 35(a)

An example of what we believe to be "ascribing greater depths of meaning" to wording contained in the Accounting Standards, we refer to paragraph 35(a) of AASB 116. Prior to its replacement by AASB 2014-1, this paragraph read:

"35. When an item of property, plant and equipment is revalued, any accumulated depreciation at the date of the revaluation is treated in one of the following ways:

(a) restated proportionately with the change in the gross carrying amount of the asset so that the carrying amount of the asset after revaluation equals its revalued amount. This method is often used when an asset is revalued by means of applying an index to determine its depreciated replacement cost; or "

Read in the context of revaluations based on the use of indices, this wording presents no difficulty. However, an issue emerged when the gross carrying amount of the asset and the carrying amount were separately revalued (i.e. not by the use of indices) or when estimated useful lives were adjusted in accordance with AASB 116.51, and this was succinctly expressed by the IASB in paragraph BC4 (page 52) of ED 225 *Annual Improvements to IFRSs -2010—2012 Cycle:*

"BC4 In such cases, divergent views exist as to how to compute the accumulated depreciation when the item of property, plant and equipment is revalued:

(a) Some think that the restatement of the accumulated depreciation is not always proportionate to the change in the gross carrying amount and paragraph 35(a) should be amended accordingly.

(b) Others are of the opinion that the accumulated depreciation and the gross carrying amount should always be restated proportionately when applying paragraph 35(a). The difference between:

(i) the amount required for a proportionate restatement of the depreciation; and

(ii) the actual restatement of the depreciation required for the gross carrying amount to result in a carrying value equal to the revalued amount should be treated as an accounting error in accordance with IAS 8 Accounting Policies, Changes in Accounting Estimates and Errors."

1. Member # 17308, admitted 19 June 1975; advanced to Fellow 20 September 1999.

Coalface

DG & AB Maxwell
Consulting Accountants
PO Box 5450
Wagga Wagga NSW 2650

DEFINITION OF RESIDUAL VALUE

Further Submission

In effect, the issue related to the weight to be attributed to the word *proportionately* in circumstances other than those envisaged when the paragraph was drafted, which were really only applicable when the indexation technique referred to in the second sentence of the paragraph was used.

As a result of its deliberations, the IASB adopted the approach in BC4(a) and amended the wording to the following[2]:

"35 When an item of property, plant and equipment is revalued, the carrying amount of that asset is adjusted to the revalued amount. At the date of the revaluation, the asset is treated in one of the following ways:

(a) the gross carrying amount is adjusted in a manner that is consistent with the revaluation of the carrying amount of the asset. For example, the gross carrying amount may be restated by reference to observable market data or it may be restated proportionately to the change in the carrying amount. The accumulated depreciation at the date of the revaluation is adjusted to equal the difference between the gross carrying amount and the carrying amount of the asset after taking into account accumulated impairment losses; or"

THE DEFINITION OF *RESIDUAL VALUE*

"The *residual value* of an asset 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."[3]

THE CONTEXT OF THE DEFINITION

In dealing with *Property, Plant & Equipment*, by far the most common method of disposition of an asset at the end of its useful life is the physical removal of the asset from the entity's possession and its disposal by sale or scrapping.

We submit that it is reasonable to assume that this was the context envisaged by the standard-setters when this wording was developed. It frequently happens, and we submit that this would have been within the contemplation of the standard-setters, that an asset has to be dismantled *in situ* in order to be disposed of, and that the asset is disposed of in sections or parts.

We further submit that the existence of a class of assets where the materials would be salvaged and re-used in the construction of a new, but similar, asset would not have entered their contemplation.

Within the context for which the definition was developed, it is perfectly reasonable and of extremely wide applicability.

We argue that, given the context for which the wording of the definition was developed, there is nothing within the definition that ***demands*** that there be a sale of the asset even though there is clearly an assumption that a sale is the most common method of disposal of assets.

"AMOUNT"

> "The residual value of an asset 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."

---

2. AASB 2014-1 Pt A made 4 June 2014.
3. AASB 116.6 Definitions

Coalface
DG & AB Maxwell
Consulting Accountants
PO Box 5450
Wagga Wagga NSW 2650

DEFINITION OF RESIDUAL VALUE

Further Submission

We draw to your attention that the standard-setters chose to use the word ***amount*** rather than the word ***consideration***. Use of the word *consideration* would have made it certain that the envisaged disposal of the asset would be by way of *sale.*

Their choice of the word *amount* certainly suggests that it was within their contemplation that the disposition of the asset at the end of its useful life may be by a method other than sale.

An amount may be a quantity or sum[4]. If a quantity, it needs to be probable that future economic benefits associated with the item will flow to the entity, and to have a cost or value that can be reliably measured[5].

Of the three senses of the noun *amount* provided by our dictionary not one refers to a sale or purchase, and to limit the word to mean *consideration* is to use it otherwise than in its normal sense.

OBTAIN

> "The residual value of an asset 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."
>
> **obtain**
> 1. ***verb*** *trans*. Come into possession or enjoyment of; secure or gain as the result of request or effort; acquire, get. ...

Although the word *obtain* is very commonly used in the sense of acquiring or gettiing something from a third party, the sense of *obtaining relief from an itch by scratching* is also very commonly used, and no third party is involved.

Thus there is no ***necessary*** implication in the use of this word that restricts it to a sale and purchase arrangement, and any such restriction is outside of its normal use.

“DISPOSAL”

> "The residual value of an asset 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."

Again, we draw to your attention to the fact that the standard-setters chose to use the word ***disposal*** rather than the word ***sale.***

The choice of the word *disposal* suggests that it was within their contemplation that the disposition of the asset at the end of its useful life may be by a method other than sale.

Disposal is the act of disposing of or getting rid of, and in turn *dispose* means to get rid of or deal conclusively with. The definition of *resdiual value* clearly envisages that there may be costs associated with this process. The important part of this definition however is that *disposal* is *“dealing conclusively with”.* Again, “dealing conclusively with” does not demand a sale.

Of the six senses of the noun *disposal* and the twelve senses of the verb *dispose* provided by our dictionary not one refers to a sale or purchase, and to limit these words to refer only to that method of disposal is to use these words other than in their normal sense.

---

4. We have used the *Shorter Oxford English Dictionary,* fifth edition, Oxford University Press 2002 as our dictionary reference throughout.
5. AASB 116.7

DG & AB Maxwell
Consulting Accountants
PO Box 5450
Wagga Wagga NSW 2650

DEFINITION OF RESIDUAL VALUE

Further Submission

"USEFUL LIFE"

> "The residual value of an asset 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**."

This term is itself defined in the Standard:

> *Useful life* is:
> (a) the period over which an asset is expected to be available for use by an entity; or
> (b) the number of production or similar units expected to be obtained from the asset by an entity.

The definition refers to **an** [entire] **asset** as distinct from the materials of which the asset is comprised, and to the period during which the asset is **available for use** by the entity.

"RESIDUAL VALUE"

It is possible, but unlikely, that the term *residual value* was chosen because it "looked good". But the ordinary meaning of these words, taken together, is the value of that which is left [at the end of the asset's useful life]. And this is entirely consistent with the meaning of the words in the definition, taken together.

The significance of *residual value* is that is a factor used in determining the *depreciable amount* of an asset:

> *Depreciable amount* is the cost of an asset, or other amount substituted for cost, less its residual value[6].

In turn, this affects the annual depreciation charge as for any given depreciation method the two operating variables are *depreciable amount* and *useful life*[7].

Interpretation 1055 *Accounting for Road Earthworks*

The Board has previously addressed issues in relation to the *useful life* of road earthworks in this Interpretation, initially released as UIG Abstract 55 *Accounting for Road Earthworks*. It addresses issues that originally arose with the adoption of former Accounting Standard AAS 27 *Financial Reporting by Local Governments* which commenced 1 July 2003[8]. The terminology used in the Interpretation reveals its heritage, as it is more consistent with the former Accounting Standard AAS 4 *Depreciation* than with AASB 116.

Although the Interpretation refers to a number of different roadworks components - and concentrates on *earthworks* - it does not embrace the concept of componentisation of assets as embodied in AASB 116. Indeed, it took the local government industry some time to recognise the importance of identifying separate components of complex assets, a process that is continuing and regrettably is not as advanced in some Councils as it should be.

6. AASB 116.6 Definitions
7. "*Depreciation* is the systematic allocation of the depreciable amount of an asset over its useful life." - AASB 116.6 Definitions.
8. [I think.] In NSW it commenced 1 January 1994 with a 6 month reporting period from 1 January 1994 - 30 June 1994.

DG & AB Maxwell
Consulting Accountants
PO Box 5450
Wagga Wagga NSW 2650

DEFINITION OF RESIDUAL VALUE

Further Submission

The Interpretation requires that "the depreciable amount of road earthwork assets that have limited useful lives shall be allocated on a systematic basis over their useful lives"[9]; that "road earthwork assets that are assessed as not having a limited useful life shall not be depreciated"[10]; and that "the depreciation or non-depreciation of road earthwork assets shall be reviewed at the end of each accounting period"[11].

We note that the Interpretation uses the term *depreciable amount* - the amount determined after allowing for any *residual value* - and that the terminology is that of AAS 4 rather than AASB 116.

It is within this context that paragraph 19 of the Interpretation should be considered:

> 19 However, if earthworks are replaced during the reconstruction of a road, the earthworks (or the appropriate portion) are derecognised and the cost of the replacement earthworks is recognised as an asset in its place. This approach is consistent with the requirement in AASB 116 that an item of property, plant and equipment ceases to be recognised on its disposal.

We submit that this is tantamount to saying that the re-used portions of the earthworks are the *residual value* of the previous earthworks prior to reconstruction, in that only "the appropriate portion" is derecognised.

PRINCIPLES-BASED ACCOUNTING STANDARDS

As we understand it, it is stated AASB policy to develop principles-based accounting standards, and the former industry-specific standards such as AAS 27 have been removed. This approach requires that although *practicability* of application of proposed standards is an important consideration, the Board is indifferent to the financial consequences of the application of those principles.

We therefore submit that the existence of alternative methodology that may (or may not) result in similar financial consequences is a matter that should be extraneous to the standard-setting process - or to the interpretation of the resulting standards.

Our Further Submission has raised serious issues in relation to the practicability of application of a methodology that requires the identification of components within homogenous assets.

However, the interpretation of *residual value* that we support is a very practical alternative. It merely requires the use of a notional "sale" of the salvage value of the predecessor asset and its "purchase" by the replacement asset. (The notional "sale" and "purchase" would occur entirely within the asset register, and would be eliminated in the preparation of the general purpose financial reports.)

It does not make the assumption that the predecessor asset would be replaced immediately at the end of its useful life[12] - once the depreciable amount has been fully allocated, no further depreciation charge would be made, exactly the same as for any other asset pending disposal.

---

9. Interpretation 1055.6
10. Interpretation 1055.7
11. Interpretation 1055.8
12. As shown in the diagram reproduced in the Staff Issues Paper - Agenda paper 8.2, February 2015 meeting.

DG & AB Maxwell
Consulting Accountants
PO Box 5450
Wagga Wagga NSW 2650

DEFINITION OF RESIDUAL VALUE

Further Submission

SUMMARY

We submit that the AASB should review its tentative agenda decision, giving specific consideration to the following points:

- There exist classes of assets that are outside the context within which the definition of *residual value* was developed.
- Neither the definition of *residual value* nor any of the words within the definition ***demand*** the sale of the asset to a third party for consideration at the end of the asset's useful life.
- None of the meanings given in our reference dictionary for the nouns *amount* and *disposal*, or for the verb *dispose*, directly refer to a *sale* or to consideration for a *sale.* We contend that the words in an accounting standard must be given their ordinary meaning unless they are elsewhere defined in that or another accounting standard.
- According to our reference dictionary, the verb *obtain* includes, **but is not limited to**, acquiring or getting [from a third party]. The ordinary use of the word includes gaining as the result of [one's own] effort.
- There is an apparent inconsistency between the tentative agenda decision and Interpretation 1055, especially when the context in which the Interpretation was developed is taken into account.
- The matter referred to in the second last paragraph of the tentative agenda decision[13] is irrelevant to consideration of a matter in the development or interpretation of principles-based accounting standards.
- The alternative procedure proposed by the Board is not practical, and practicability *is* a matter that should be considered in the development or interpretation of principles-based accounting standards.

---

13. http://www.aasb.gov.au/admin/file/content102/c3/Tentative_Agenda_Decision_February_2015.pdf

DG & AB Maxwell
Consulting Accountants
PO Box 5450
Wagga Wagga NSW 2650

DEFINITION OF RESIDUAL VALUE

Further Submission

ABOUT THE AUTHOR

The author was admitted to membership of the Institute of Chartered Accountants in Australia on 19 June 1975, and qualified under the then South Australian regulations as a Local Government Auditor in November 1975. He acted as signing partner in the late 1970s - early 1980s for a number of Councils in the mid-North of South Australia including the then District Councils of Clare, Burra Burra, Hallett, Red Hill, Hawker, Carrieton and Orroroo.

Becoming disenchanted with taxation work, with Ministerial approval he was appointed in 1982 as CEO of the District Council of Robertstown, qualifying as a CEO in 1985. In advance of the SA amalgamations of Councils, he transferred to Balranald Shire Council in NSW in 1989, serving as Deputy Shire Clerk.

With the advent of the new NSW Local Government Act 1993, and coincidentally the introduction of AAS 27, his financial accounting skills in a local government environment were in demand and he commenced practice as a specialist consultant to local government in the areas of finance and administration in 1995. He developed various accounting tools to assist local government officers in the preparation of annual financial statements that are in use in every State in Australia.

He was advanced to Fellowship in the Institute of Chartered Accountants in Australia on 20 September 1999, and has been a judge of the NSW Local Government Finance Professionals Annual Statements Award since its inception in 2001. He is currently contractor to the Local Government Association of SA for the preparation of the SA Model Financial Statements, and serves on a number of Council Audit Committees.

He is a member of NSW LG Professionals (including the Finance Professionals SIG), SA Local Government Financial Management Group and an affiliate member of NSW Local Government Auditors Association.

DG & AB Maxwell
Consulting Accountants
PO Box 5450
Wagga Wagga NSW 2650