Staff Issues Paper
Staff Collation and Analysis of Comment Letters

Purpose

1 The purpose of this paper is to provide the Board with a summary of the feedback received on its Tentative Agenda Decision *Recognition of Residual Value for Infrastructure Assets*[1] with a view to seeking a final Board decision on the issue.

Due Process / Outreach Activity

2 The comment period on the Tentative Agenda Decision closed 20 April 2015. The AASB received 19 comment letters, including updated/supplementary submissions to feedback received during the Board's initial deliberations and joint submissions from various local governments. Respondents were as follows:

(a) Local Governments[2]: Temora Shire Council, NSW Northern Rivers councils (comprising 6 councils), Marrickville Council, Kempsey Shire Council, Mackay Regional Council, Mid-Western Regional Council, South Australian Local Government Financial Management Group (representing 60 councils), Willoughby City Council, Local Government Professionals Australia NSW, Local Government Association of Queensland (representing 77 Queensland councils), Townsville City Council[3];

(b) APV Valuers and Asset Management (APV);

(c) DG & AB Maxwell (the original submitter);

(d) LG Solutions;

(e) Local Government Auditors Association of New South Wales;

(f) Liquid Pacific (valuers and land economists);

(g) Australasian Council of Auditors-General (ACAG); and

(h) Institute of Public Works Engineering Australasia (IPWEA).

3 Submissions were made by constituents operating predominantly in New South Wales and Queensland. The majority of comment letters received indicated a strong preference for View 2 as expressed in the Tentative Agenda Decision – that is, that the

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1 Link to the Tentative Agenda Decision: http://www.aasb.gov.au/admin/file/content105/c9/Proposed_Agenda_Decision_February_2015.pdf

2 Staff consider the submissions received from Temora Shire Council (submission 3), Marrickville Council (submission 5), Kempsey Shire Council (submission 6), Mackay Regional Council (submission 8) and Mid-Western Regional Council (submission 9) to be in the nature of 'form' submissions, based on wording suggested by LG Solutions (submission 7). Submissions received from Willoughby City Council (submission 12) and Local Government Professionals Australia NSW (submission 13) are also largely based on wording suggested by LG Solutions, but also includes comment on the impact of the agenda decision to local governments.

3 Submission 16B, submitted as a supplementary submission to the comment letter from Local Government Association of Queensland.

definition of residual value includes the cost savings from the re-use of in-situ materials. Several submissions received from local governments also requested the Board redeliberate the arguments of the original submissions put forth by APV and DG & AB Maxwell. However, staff note that new submissions from both these parties were received during the exposure period.[4]

4 Submissions from Liquid Pacific (submission 14), ACAG (submission 15) and IPWEA (submission 17) expressed clear support for View 1 – that is, that the definition of residual value does **not** include the cost savings from the re-use of in-situ materials. In addition to comment letters received, staff sought informal feedback from a valuation expert from a Big 4 audit firm whose clientele includes public sector entities, and also received feedback from a member of the Royal Institute of Chartered Surveyors. Both of these parties were not supportive of View 2. Staff also heard informally of support for View 1 by a government representative body.

5 During the exposure period, staff also met with several constituents (David Maxwell – the original submitter, David Edgerton from APV and John Howard from IPWEA) who had submitted comment letters in response to the Board's Tentative Agenda Decision. Staff/Ann Tarca also discussed the Tentative Agenda Decision at the CAANZ Business Forum in Perth, at recent meetings of the South Australian Local Government Financial Management Group (SALGFMG) and Financial Reporting & Auditing Committee of the ACAG.

6 Further, staff sought feedback from NZASB staff and Chartered Institute of Public Finance and Accountancy (CIPFA)[5] staff, as to whether the issue had arisen in their respective jurisdictions. Staff have not received feedback that other jurisdictions have before encountered the practice of including cost savings associated with the reuse of in-situ materials as part of an asset's residual value.

7 Staff note that the AASB had not received any submissions from for-profit entities or not-for-profit private sector entities. This is consistent with the initial targeted outreach conducted in Q4 2014 – Q1 2015[6], which suggested that the issue is predominantly a not-for-profit public sector concern.

8 This agenda paper is organised as follows:

(a) Paragraphs 9 – 26 summarises and analyses arguments for and against the Board's view expressed in the Tentative Agenda Decision. Board members are asked whether they continue to support the view that the definition of residual value does not include cost savings from the re-use of in-situ materials;

(b) Paragraphs 27 – 35 are based on the presumption that Board members continue to support View 1 of the Tentative Agenda Decision. In these paragraphs, staff summarise and analyse arguments put forward by proponents of View 2 for explicitly permitting View 2 to be applied, at least by not-for-profit entities, in practice. Board members are asked whether they would support including such an exception to AASB 116 for not-for-profit entities;

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4 Refer the submissions noted in footnote 2.
5 CIPFA is a UK professional accountancy body specialising in public services.
6 Reported to the Board in Agenda Paper 8.2 of the AASB February 2015 meeting: http://www.aasb.gov.au/admin/file/content102/c3/M143_8.2_Residual_Value_Issues_Paper.pdf

(c) Paragraphs 36 – 40 summarise transitional concerns of not-for-profit public sector entities, if the Tentative Agenda Decision is finalised substantially as exposed. Board members are asked whether they agree with the staff recommendation not to introduce any transitional provisions that would assist entities in addressing their transitional concerns;

(d) Paragraph 41 – 42 note related other issues that have been brought to staff attention during the consultation process. Board members are asked whether they agree with the staff recommendation not to take any action in respect of these other issues; and

(e) Paragraphs 43 – 47 address possible alternatives for progressing this project. These include finalising the Board's proposals largely as exposed (see Appendix A to the agenda paper). Board members are asked whether they agree with the staff recommendation to finalise the agenda decision as reworded in Appendix A.

Arguments For and Against the Board's Tentative View

9 AASB 116.6 defines the residual value of an asset as:

> *"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"*

10 The Tentative Agenda Decision responds to the question as to whether residual value can include cost savings of the entity that arise on reuse of in-situ materials. Some feedback received related to tangential, or non-substantive matters such as confusion arising from terminology used, extending the discussion to other more physically distinct components of the larger asset, or distinguishing between different parts or types of roads. Staff have not included such comments in summarising and analysing the feedback received to the extent it does not pertain to the principle addressed in the Tentative Agenda Decision; however, staff note that all comment letters received have been included as Agenda Paper 5.3 for Board member consideration.

11 In the main, staff think that the comment letters received were written in the context of the application of the Tentative Agenda Decision to roads, rather than other infrastructure or long-lived assets, as this was the topic of the original submission and original Board discussion. Staff think that the underlying principle remains the same, and so are not unduly concerned that the focus of the submissions is on roads. Staff note that it is commonly accepted that "roads" are separable into at least several physically distinct parts.

<u>In Support of View 1 (residual value excludes cost savings from re-use of asset)</u>

12 Staff did not receive any feedback reflective of technical arguments in support of View 1 beyond those considered by the Board in forming its Tentative Agenda Decision. Staff instead received feedback arguing why View 2 should not be formalised as an acceptable interpretation of residual value, as follows:

(a) Some respondents expressed concern that entities prefer View 2 as it allows for management of depreciation expense. A respondent expressed a view that "local government shuns [depreciation] expense as it permeates measures that reflect 'sustainability'";

(b) Some respondents noted concern that formalising the inclusion of cost savings from re-use of in-situ materials in the definition of residual value would, in some instances, elevate 'residual value' to something more than that envisaged by AASB 116.53, which describes the residual value of an asset as being often insignificant in practice[7]; and

(c) A respondent expressed a concern that formalising View 2 may lead to not-for-profit public sector entities extending the 'residual value' practice to assets other than roads.[8]

<u>In Support of View 2 (residual value includes cost savings from re-use of asset)</u>

13 As noted in paragraph 3, the majority of comment letters received expressed support for View 2. The key technical argument proposed in favour of View 2 is that the definition of residual value should be read broadly and accordingly, could include amounts retained for reuse by the entity.

14 Some respondents argue that the IASB would not have considered the reuse by the entity of parts of an asset in developing the definition of residual value, and that the choice of words employed in the definition is indicative that:

(a) disposal by sale or for consideration is not the only possible outcome; and

(b) cost savings from reuse of materials is the amount an entity would "currently obtain from disposal of the asset", as the word 'amount' and 'obtain' in the definition of residual value can be read to include consideration or other cash inflows, or also cost savings.

15 Further, a respondent argued that local governments would reasonably expect to receive consideration for the sale of the recycled material – if it were sold – and accordingly, recognising the savings on the purchase of replacement materials is not dissimilar, and therefore reflects a reasonable inclusion in residual value.

16 In arguing that View 2 is a valid interpretation of the definition of residual value, some respondents also reflected disagreement with the Board's view that an asset may be further componentised into non-clearly physically distinguishable parts. Some respondents expressed a view that it is not appropriate to separately distinguish an asset into shorter useful life/ longer useful life parts in situations where the amount of the distinction is in the nature of an estimate. Others were concerned that it was not possible to identify the physical parts of a homogenous asset consumed over different useful lives. Staff note that the feedback received reflects that some entities regard stabilisation/ restoration/ remediation activity as the creation of a new asset (for example, the road pavement as they also consider that the asset cannot be further

7 For example, submission 14 and submission 16A describe instances of the residual value of certain parts being determined in excess of 50% of the value of the part.

8 That respondent also considered that valuations were being prepared to meet other needs of the entity, rather than for use as an independent tool for management purposes, and may not be consistent with the objectives of AASB 13.

componentised) that requires derecognition of the existing 'old' asset in its entirety. Any remaining service potential in the 'old' asset is 'realised' through the transfer of an amount representing those future economic benefits to the new asset.

17 The definition of residual value includes reference to the asset's useful life. AASB 116.6 defines useful life as:

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.

18 In summarising the arguments in support of View 2, staff think that support for the arguments put forward in paragraphs 14 – 16 above is dependent on the presumption that the remediation point is a valid reflection of the useful life of the asset, including the useful life of any separately distinguished part thereof.[9] Some respondents supporting View 2 argue that it is appropriate to consider that the remediation point reflects the useful life of the asset as, without the remediation activity, the remaining part of the asset will no longer be available for use.

Staff view

19 Consistent with the Board's view implicit in the Tentative Agenda Decision, staff continue to **disagree** that a part of an asset needs to be clearly physically distinguishable in order to qualify for componentisation and be separately depreciated. Staff note that, for example, AASB 116.14 requires major inspections or overhaul activity to be incorporated into the cost of an asset (that is, as a 'component' or 'part') – such activity may not have a physically separately identifiable component. Staff reviewed the guides produced by the Big 4 accounting firms, and note that none of the books express that parts need be physically distinguishable to be separately depreciated for the purposes of AASB 116.[10,11]

20 Similarly, staff continue to **disagree** that a remediation point is a valid interpretation of the useful life of the part of the asset that reflects future economic benefits that will continue to be available after some remediation activity. Staff note that AASB 116.57 states that useful life is defined in terms of the asset's expected utility to the entity. Accordingly, staff consider that those parts which are unable to be used without intervention at some point during the life of the asset in its entirety may still have a useful life that is longer than the remediation point. Staff also note that the Deloitte

9 Otherwise, there may be little or no material suitable for re-use.

10 Further, staff note that some of the guides state that the costs of such components will need to be estimated generally by reference to the current cost of the expected overhaul – i.e. the exact costs need not be known.

11 As noted in paragraph 16 above, some proponents of View 2 may regard stabilisation/ restoration/ remediation activity as the creation of a new asset that requires derecognition of the existing asset in its totality. However, staff note the part of the existing asset that continues to exist after the such activity is to form part of the new asset rather than being written off to profit and loss at that time – that is, the 'single asset' logic is not carried through to its logical conclusion.

iGAAP 2015 guide includes an example of ships and dry dock overhaul consistent with this staff view.[12]

21 Staff agree that the definition of residual value does not envisage that disposal by sale is the only possible outcome. This is clear in AASB 116 *Property, Plant and Equipment*, as AASB 116.69 notes disposal could be, for example, by way of entering into a finance lease or by donation. However, staff continue to consider that 'disposal' involves an expectation that control of the asset is relinquished. Accordingly, if there is no loss of control of the asset (or part thereof), the asset (or part thereof) should not be derecognised. At a remediation point, it may be that control of only part of an asset has been lost and that part of the asset disposed.[13]

22 Staff **disagree** with the view expressed in paragraph 14(b) that the choice of words in the definition of residual value contemplates the inclusion of cost savings. Staff do not think that interpreting the words 'amount' or 'obtain' in the manner represented is a valid interpretation of the definition.

23 From the staff review of the comment letters and other feedback received, staff consider that the main underlying technical issue of contention that is being drawn out in the discussion about 'residual value' is whether it is appropriate, under Australian Accounting Standards, for the separately unidentifiable portion[14] of a composite asset whose future economic benefits would be only be consumed at a future point in time to be considered as non-depreciable for a period, even though the asset is currently available for use. Staff think that this is the key difference between View 1 and View 2 in the Tentative Agenda Decision, as effectively, the proponents of View 2 consider part of the asset to be non-depreciating in nature.

24 Staff think that AASB 116.55 is clear that an asset should be depreciated from the time it is available for use, even it remains idle for a period. Accordingly, staff **do not agree** with the accounting outcome that results from application of View 2. Contrary to the treatment of the cost savings as part of the asset's residual value, staff think that the accounting for stabilisation/ restoration activity of roads, or similar infrastructure, is **no different to major overhaul activity** undertaken of certain other assets, for example, ships and aircraft.[15] In these instances, AASB 116.13-14 require the separate identification, depreciation and derecognition of the cost of the overhaul activity as a component of the asset.

25 Staff are especially concerned with the application of View 2 in practice where residual values have been determined to be 50%-65% of the asset's value[16]. As noted in paragraph 12(b) above, this appears to be contrary to the intentions of the Standard.

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12 Refer Example 7.2 on page 460 of Deloitte iGAAP 2015.

13 Staff note that it received informal feedback from one respondent that they consider that control of the asset has been lost, as the 'asset' is the asset in its entirety rather than parts thereof.

14 This portion has been described in different manners, including "residual value", "recyclable asset" and "preserved value".

15 However, staff note that proponents of View 2 are likely to argue that, unlike ships and aircrafts, the current configuration of the road which is comprised of the component materials has reached the end of its useful life (at a given standard).

16 See submissions by Liquid Pacific and LGAQ (Agenda Paper 5.3, Submissions 14 and 16A).

26 Accordingly, staff continue to support View 1 of the Tentative Agenda Decision. Under this view, the definition of residual value does not include cost savings from the re-use of in-situ materials.[17]

Question to Board Members:

Q1 Do Board members agree with the staff recommendation to continue to support the view that the definition of residual value does not include cost savings from the re-use of in-situ materials?

Arguments for Creating an Exception for Not-for-Profit Entities

27 Paragraphs 28 – 35 only apply where the Board agrees with the staff recommendation in paragraph 26 above.

28 As part of the feedback received, some respondents suggested (either expressly or implicitly) that View 2 be legitimised as a not-for-profit entity **exception** to the Standard[18], in the event that their rationale in support of View 2 were not considered by the Board to be valid arguments. Respondents put forward the following reasons for being permitted to apply View 2 in practice:

(a) *View 2 is preferable as it aligns financial reporting requirements with asset management registers*

Some respondents (who currently apply View 2) assert that further componentisation would create the following problems:

(i) A single financial/operating register could not be utilised as the financial register would have more components than the operational register;

(ii) Links between the financial and operating registers would not be possible if financial assets were further componentised;

(iii) Links between financial asset registers and Geographic Information System (GIS) spatial asset registers would not be possible if financial assets were further componentised; and

(iv) Any residual values used are reflective of how the infrastructure networks are currently being managed.

(b) *View 2 is preferable as it is a better reflection of the true economic consumption of the asset*

A respondent noted that if the Board's view that cost savings did not form part of residual value were reflected in the final agenda decision, the failure to further componentise would result in overstatement of annual depreciation.

17 Following the feedback received, staff recommend amending the wording of the Tentative Agenda Decision, including the wording in View 1, to better explain the reasons for not adding the issue to the AASB's agenda.

18 A respondent suggested that the Board could alternatively consider clarifying componentisation to address the manner in which non-physical parts can be separated, or adopting a 'preserved value' notion.

Another respondent noted that the Board's view, if finalised in the manner noted in the Tentative Agenda Decision, would result in uncertain depreciation impacts across entities, depending on the extent to which these entities have applied View 2. Some respondents were of the view that View 2 also provides a better reflection of the true economic consumption of the asset in its entirety, as parts of the asset are not depreciated until actually in use.

(c) *View 2 is preferable as audit evidence supporting the 'unused' component is easier to obtain than audit evidence supporting a long useful life of that component*

Some respondents were concerned that it would be difficult to determine the useful lives of residual components with any reliability given the potential extraordinary long life of some materials. For example, the LGAQ submission (submission 16A) reported significant variability in the useful lives of road components between Queensland local governments.

(d) *View 2 is preferable as increased componentisation means increased costs*

A respondent noted a preference for continuing current practice, noting that View 2 is easier to apply in practice. Some respondents expressed concern that increased componentisation would increase the variability and complexity in the valuation of infrastructure assets, and increased asset management and valuation costs associated with the increased number of components that need to be maintained and managed.

Staff view

29 Staff concur that View 1 may initially result in some differences arising between the financial and current asset management registers. However, staff understand from its initial outreach process that Tasmanian councils have been able to create further components in their asset registers. Accordingly, staff do not regard this to be a valid reason for supporting an exception to the Standard.

30 Staff note that some respondents were of the view that View 2 is used by entities to manage operating results through manipulating the depreciation expense.[19] Staff observe that taken to the extreme, it is possible that nil depreciation is charged against an asset that is in use, should View 2 be legitimised. For this reason, staff **disagree** with the argument that View 2 is a better reflection of the true economic consumption of the asset. Staff think that separately depreciating parts of an asset with differing useful lives is a better reflection of the true economic consumption of the asset, and note that the Standard acknowledges that a part of an asset that is 'available for use' but not yet in use may still be subject to depreciation.

31 Staff do not disagree that the determination of a limited useful life is subject to judgement. However, staff do not consider this to be a good reason for not determining a useful life, and note that AASB 116 requires the useful life and residual value of an asset to be reviewed annually. Further, staff understand from feedback

19 Staff note that the same assertion is made by View 2 proponents of View 1; that depreciation expense is manipulated through the choice of useful life.

received that in the instance of road assets, the materials that are used to construct the asset generally have an attached life expectation (e.g. before degradation).

32 Staff agree that the asset register may expand with the increased componentisation. From feedback received and where the assets are measured on the fair value basis, staff do not think that the additional valuation required will be significant in practice. Staff do not think that additional costs incurred in this respect is sufficient reason to not comply with the requirements of the Standard. Further, staff understand that the Tasmanian councils have demonstrated that componentisation can be applied and managed in practice.

33 While not raised in the feedback received, staff also think that the preference for View 2 may partly be to align depreciation for financial reporting purposes with the 'depreciation' measure that may be employed in estimating an asset's fair value by reference to its depreciated replacement cost.[20] However, staff do not think this is a valid reason for departing from the requirements of Australian Accounting Standards.

34 Further, staff note that the arguments described in paragraph 28 above are not specific to not-for-profit entities, but apply equally to for-profit entities. Staff consider that not creating an exception for not-for-profit entities in this regard would be more in keeping with the Board's transaction neutrality policy.

35 On balance, considering the arguments put forward in paragraph 28 above and the staff views noted in paragraphs 19 (componentisation) and 20 (useful life), staff consider that an exception to AASB 116 to allow cost savings to be considered as part of residual value would **not** be appropriate.

Question to Board Members

Q2 Do Board members agree with the staff recommendation <u>not</u> to create an exception for not-for-profit public sector entities that would allow the current practice of incorporating cost savings in determining the asset's residual value to continue?

Transitional Concerns of Respondents

36 The Tentative Agenda Decision notes the Board's view that 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.

37 Staff received feedback during the exposure period that this view is not necessarily valid, and that it is possible for the difference in annual depreciation expense to be materially different under the two approaches. This may be the case where the amount included in residual value has been a significant portion of the asset's value. In their

20 International Valuation Standards Board (IVSC) Technical Information Paper 2 *The Cost Approach for Tangible Assets* (TIP 2) specifies that the value of an asset will not be below its value for an alternative use, including for scrap, salvage and recycling, less the costs of clearance, decommissioning and any decontamination required. Paragraph G9 of International Valuation Standard (IVS) 300 *Valuations for Financial Reporting* notes "The term depreciation is used in different contexts in valuation and in financial reporting. In the context of valuation, depreciation is often used to refer to the adjustments made when using the cost approach to the cost of reproducing or replacing the asset to reflect obsolescence in order to indicate the value of the asset when there is no direct sales evidence available. …"

submission (Submission 16A), the LGAQ have included the following example illustrating the difference in periodic depreciation under View 1 and View 2:[21]

A 1kmX 8m wide road section has a replacement pavement cost $60/m2. A 150mm stabilisation treatment is planned at $25/m2. The short term pavement life is 50 years and the long term pavement component life is estimated as 100 years. The assumption of 100 years for the long term pavement infers that the pavement is to be replaced or the road decommissioned at 100 years.

Table 4: Comparison of Using Residual Value and Residual Component

Method 1: -Conventional Residual Value Approach	Method 2:-Proposed Residual Component Approach
Based on expected treatments for specific segment First 50 years Replacement Value = $60/m2 or $480,000 Rehabilitation rate= $25/m2 Residual value = $60-$25=$35 or $280,000 Depreciable Amount = $200,000 Annual Depreciation = $4000 Written Down Value at Year 50 = $280,000 Total depreciation over first 50 years =$200,000 Second 50 years Replacement Value = $60/m2 or $480,000 Rehabilitation rate= $60/m2 (pavement replaced) Residual value = $60-$60=$0 Depreciable Amount = $480,000 Annual Depreciation = $9,600 Written Down Value at Year 100 = $0 Total depreciation over second 50 years =$480,000 Total depreciation over 100 years =$680,000	Based on expected treatments for specific segment First 50 years Short Life Pavement Replacement Value = $25/m2 or $200,000 Residual Value =0 Depreciable amount = $200,000 Annual Depreciation = $4000 Long Life Pavement Replacement Value =$60-$25=$35 or $280,000 Residual Value = 0 Depreciable amount = $280,000 Annual Depreciation = $2800 Total Depreciation = $6,800 Written Down Value at Year 50= $140,000 Total depreciation over first 50 years = $340,000 Second 50 years Short Life Pavement Replacement Value = $25/m2 or $200,000 Residual Value =0 Depreciable amount = $200,000 Annual Depreciation = $4000 Long Life Pavement Replacement Value =$60-$25=$35 or $280,000 Residual Value = 0 Depreciable amount = $280,000 Annual Depreciation = $2800 Total Depreciation = $6,800 Written Down Value at Year100= $0 Total depreciation over second 50 years = $340,000 Total depreciation over 100 years = $680,000

38 Having regard to the feedback received, staff think that the wording of the Tentative Agenda Decision should be reworded to soften the presumption that an entity would arrive at a similar outcome under both Views. Appendix A to this agenda paper includes some suggested rewording of the Tentative Agenda Decision; however, the Question to Board members below does not ask Board members whether they agree with that wording (this is asked of Board members later in this agenda paper as Q6).

Question to Board Members

Q3 Do Board members agree with the staff recommendation to amend the wording of the Tentative Agenda Decision to soften the presumption that an entity would arrive at a similar outcome under both Views?

39 The LGAQ also noted that entities currently adopting View 2 may incur significant transitional issues associated with implementing an alternative approach, including the establishment of the additional components in infrastructure asset registers. The

[21] See also the initial testing results of Townsville City Council included in Submission 16B.

submission noted that for councils with large networks, this is a major task, and that local governments would need time and support to implement the necessary changes.

40 Staff note the potential difficulties in the timing of the Board's discussions in respect of 30 June 2015 year ends, but do not recommend any transitional provisions be introduced, to the extent the Board does not think the Standard is unclear in this regard. (Staff note that an Agenda Decision cannot include transitional provisions as it is not part of Australian GAAP. Should Board members disagree with the staff recommendation, the Board's decisions on this issue cannot be finalised in the form of a final Agenda Decision.)

Question to Board Members

Q4 Do Board members agree with the staff recommendation not to introduce any transitional provisions?

Other Issues Raised in Submissions

41 From some submissions/feedback received, staff understand that some entities may be determining annual depreciation expense as a proportion of the estimated future economic benefits in the asset that are expected to be consumed between revaluation points, as opposed to determining annual depreciation expense by reference to the asset's depreciable amount over its useful life. Staff think that the applicable accounting specified by AASB 116 and Interpretation 1030 *Depreciation of Long-Lived Physical Assets: Condition-Based Depreciation and Related Methods* addressing this is clear, and recommend that the Board take no action in this regard.

42 From some submissions/feedback received, staff are concerned that there may be a view in practice that it is possible that some infrastructure assets, other than land and earthworks, may have an unlimited useful life, for example, because the asset is similar in nature to earthworks or because it is too difficult to make an estimation of its useful life.[22] Staff observe that this is a manner by which some entities may seek to manage the impact of the Board's decisions about residual value. However, staff recommend that the Board take no action in this regard, as staff consider that this is a matter to be addressed by the entity and its auditors.

Question to Board Members

Q5 Do Board members agree with the staff recommendations in paragraphs 41 and 42 not to take any action in respect of these other issues raised in submissions?

Alternatives for Progressing this Project

43 As previously noted in Agenda Paper 8.2 of the February 2015 meeting,[23] in accordance with the *AASB Interpretations and Improvements Model* (June 2006, as

22 Staff note that paragraph G3 of the Australian Implementation Guidance accompanying AASB 116 contemplates that some cultural and heritage assets may not have a limited useful life.

23 http://www.aasb.gov.au/admin/file/content102/c3/M143_8.2_Residual_Value_Issues_Paper.pdf

modified in February 2012)[24], and the *Process for Modifying IFRSs for PBE/NFP*[25], the Board could:

(a) take no action and give reasons (e.g. as an Agenda Decision);

(b) direct staff to prepare a staff article explaining the application of the definition of residual value and to provide some guidance in those areas giving rise to diversity in practice (see paragraph 46 below);

(c) refer the issue to the IFRS Interpretations Committee for consideration; or

(d) add the issue to the work program.

Staff view

44 Staff note that some of the feedback received suggests that it would be helpful if the wording of the Tentative Agenda Decision is amended to address concerns as to the ambiguity of the part of the asset that is further componentised (that is, to remove the suggestion that it is the underlying physical materials – e.g. gravel or steel – that is the component part). Staff also suggest amendments to better clarify the rationale for not adding the item to the Board's agenda, and as noted in Q3, to soften the presumption that an entity would arrive at a similar outcome under both Views.

45 Staff recommend that the Tentative Agenda Decision be finalised as marked up in Appendix A to this agenda paper.

46 Staff note that the Board, at its February 2015 meeting, also directed staff to prepare an educative staff article on this issue. Following the feedback received, staff consider that a staff article would be helpful, but note that staff resourcing is such that an article would likely only be finalised in Q3 2015.

47 Staff do not recommend the other alternatives for the following reasons:

(a) refer the issue to the IFRS Interpretations Committee – staff note that some respondents have recommended that the issue be raised to the IFRS IC given the significance of the Board's view to local governments. Staff think the issue (definition of residual value) is not sector specific, however note that the issue is likely to be of limited practical relevance to the for-profit sector as in many cases the residual value will be immaterial. Accordingly, staff do not think the issue meets the criteria for referring the issue to the Committee.

(b) add the issue to the work program – staff do not support developing specific not-for-profit requirements in relation to residual value as staff think the definition of residual value is sufficiently clear as to its application. Further, although staff acknowledge the existence of diversity in practice, on balance staff do not support adding not-for-profit specific Application Guidance to AASB 116 on the basis that the diversity could more readily be addressed via

24 Link to the AASB Interpretations and Improvements Model: http://www.aasb.gov.au/admin/file/content102/c3/AASB_Interpretations_and_Improvements_Model_Feb_2012.pdf

25 http://www.aasb.gov.au/admin/file/content102/c3/Final_Process_for_modifying_IFRSs_Oct_2009.pdf

further education by way of a staff article, rather than amendment to the Standard.

Questions to Board Members

Q6 Do Board members agree with the staff recommendation to finalise the Tentative Agenda Decision as marked up in Appendix A?

Q7 Having regard to the likely timing of a staff article on this issue, do Board members want staff to continue to prepare the article as previously directed?

Appendix A – Marked Up Tentative Agenda Decision *Recognition of Residual Value for Infrastructure Assets*

~~Tentative~~ Agenda Decision

~~February~~ May 2015

RECOGNITION OF RESIDUAL VALUE FOR INFRASTRUCTURE ASSETS

Issue

The AASB received a request to clarify whether residual value, as defined in AASB 116 *Property, Plant and Equipment*, includes the cost savings from the re-use of in-situ materials. The submitter contended that the definition of residual value is otherwise unduly limiting in the not-for-profit (NFP) sector and requested ~~an exception~~ clarification be made for NFP entities to permit such entities to recognise the cost savings from the re-use of in-situ materials in the residual value of infrastructure assets.

Reasons for Not Adding the Issue to the AASB's Agenda

In considering this issue the AASB noted there are two views in relation to the definition of residual values for infrastructure assets:

- View 1: residual value ~~is only recognised in circumstances when an entity expects to receive~~ reflects consideration receivable 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.

The AASB noted that the definition of residual value in AASB 116 refers to the estimated amount that an entity would currently obtain from disposal of the asset at the end of its useful life. ~~That is, if significant values attach to~~ Where in-situ materials~~, and they~~ are expected to ~~be recycled~~ continue to be used, the ~~materials~~ asset may not have ~~not~~ reached the end of ~~their~~ its useful ~~lives~~ life. ~~Accordingly, t~~The AASB also considered that a residual value would only be ~~recognised when~~ reflected where an entity expects to receive consideration for ~~an~~ the asset ~~at the end of its useful life~~ on its disposal.

In considering infrastructure assets, the AASB noted that AASB 116 (paragraphs 44-45) contemplates that parts of an asset may have differing useful lives and includes guidance on the appropriate accounting treatment in such instances. The AASB ~~also~~ observed that AASB 116 (paragraph 43) requires 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 to be depreciated separately and includes guidance when parts of items of property, plant and equipment require replacement at regular intervals (paragraphs 12-14). The AASB noted that these requirements apply equally to for-profit and not-for-profit entities.

~~Accordingly, the AASB noted that 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.~~

The AASB also noted that the depreciable amount is defined as the cost of an asset, or other amount substituted for cost, less its residual value. Consequently, View 1 and View 2 above will result in differing depreciable amounts, and accordingly, annual depreciation expense, of an asset. The AASB observed that AASB 116 does not allow cost savings from the re-use of in-situ materials to be included in estimating residual value where the impact of such method on depreciation expense would be materially different from that which would be determined by reference to View 1. However, the AASB noted that the depreciation expense determined under View 2 may not be materially different from the expense that would have resulted had depreciation expense been determined by reference to a depreciable amount that excludes cost savings from the re-use of in-situ materials in estimating the residual value. The extent to which cost savings from the re-use of in-situ materials are included in residual value is likely to affect this assessment.

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.