



Local Government Auditors Association of New South Wales

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April 16, 2015

Ms Kris Peach
Chair
Australian Accounting Standards Board
PO Box 204
Collins St West
VIC 8007

Dear Kris

Tentative Agenda Decision AASB116 – Definition of Residual Value

The LGAA is pleased to respond to the tentative agenda decision issued by the Board at its February 11th meeting. The LGAA appreciates the Board's deliberations on this issue. However, as outlined below, the LGAA has broader concerns in regard to the Board's process and basis for tentatively deciding not to add this issue to its agenda.

As the body representing the majority of auditors working with NSW local government, we strongly believe that the View 1 interpretation of residual value favoured by the Board is unduly narrow and if applied, will in fact result in the production of less reliable financial information.

Please find attached our submission for the Board's consideration, if you require further explanation or commentary on any of our views expressed in this submission, please contact John O'Malley by email at john.omalley@intentus.com.au.

Yours faithfully

Wayne Russell
LGAA Chairman

AASB116 Property Plant & Equipment -

Definition of Residual Value -

Submission by NSW Local Government Auditors Association -

Background ¶

This issue has arisen following a paper commissioned by the Tasmanian Auditor General¹ which contends that “residual values should only be used where an asset has a potential market for its disposal, e.g. fleet and plant. While the desire to utilise residual values more broadly is understood, other mechanisms that more closely align with the Accounting Standards are preferred.”

That paper prompted the June 2014 submission to the AASB from DG & AB Maxwell seeking to have the AASB 116 definition of residual value 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.

In seeking feedback on this issue, AASB identified two views:

View 1 - a residual value is only recognised in circumstances where an entity expects to receive consideration for an asset at the end of its useful life. That is, recognition is limited to instances in that an entity expects to relinquish control of an asset at the end of its useful life in return for consideration ; and

View 2- residual value encompasses the cost savings in replacing an asset. That is, recognition is not limited to instances in that an entity expects to relinquish control of an asset at the end of its useful life in return for consideration

1. Residual Value

AASB 116 Property, Plant and Equipment paragraph 6 provides the following definition of the residual value of an asset:

“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 definition has been interpreted broadly as being any value that can be extracted from an asset at the end of its useful life or more narrowly as the cash value received upon the disposal of the asset.

The LGAA believes there are several key concepts contained in that definition that must each be considered when applying the definition to determine whether there is a residual value.

1.1. “estimated amount”

We note that:

- a. it is an estimate, hence it does not have to be realised through sale; and
- b. the use of the term “amount” is quite distinct from the term “consideration” which would clearly require a sale transaction. An amount may be either a cash inflow or a cost saving that does not require a sale transaction in order to be obtained.

1.2. “disposal”

AASB 116.6 does not define this term however guidance is available through paragraph 57 which, although dealing with depreciable amount and depreciable period, states:

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

¹ <http://www.audit.tas.gov.au/media/Report-of-the-Auditor-General-No.-5-of-2013-14-Infrastructure-Financial-Accounting-in-Local-Government.pdf>

In our view, the common practice of determining the end of the useful life of infrastructure assets to have occurred at the point where the asset will not be available for further use unless some form of remediation is applied, sits well with this concept of disposal and demonstrates “judgement based on the experience of the entity with similar assets.”

That view is supported by English language definitions of disposal which include the noun – to get rid of something or the phrase – to have available for use at any time.²

We are of the view that once an infrastructure asset as a whole has reached the end of its useful life and is no longer available for use, if it is remediated any remaining value (service potential) is effectively transferred to the new asset and becomes part of that new asset. We contend that this is realisation of the amount obtained from disposal of the asset i.e. its residual value.

1.3. “costs of disposal”

This term is not specifically defined by AASB 116 and we believe that it is reasonably clear that it would include advertising, commission or other costs associated with sale of the asset. Equally those costs associated with removing or scrapping material that has no further utility. The point being that disposal is not only by means of sale.

1.4. “useful life”

AASB 116.6 states 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

We see no difficulty in applying part (a) of the above definition to circumstances where an infrastructure asset is no longer available for use as a whole, notwithstanding that asset remediation may, if applied, bring the asset back into service in a new form.

² <http://www.macmillandictionary.com/dictionary/british/disposal>

2. Concerns with the views expressed by AASB staff

2.1. Absence of reasoned argument

February 2015 Agenda paper 8.2 (M143) at paragraph 26 expresses the staff view that “the definition of residual value in AASB116 does limit its application to instances in that an entity expects to relinquish control of an asset, that is at the end of its useful life, in return for consideration.”

The staff paper outlines the two views voiced by the respondents, but offers no argument based upon staff analysis of residual value as defined by the Standard, the responses garnered through the targeted outreach, or indeed any other research to support this conclusion. Given that residual value is the core issue of the original submission from DG & AB Maxwell this is seen as unhelpful.

The views of the respondent supporting view 1 which precede this conclusion and appear to be accepted by the AASB staff include:

20 The submitter contends that the cost of the recyclable component of the sealed pavement is the ‘estimated cost of planned recycling and stabilisation’. Whereas the cost of the long-life component is the cost of construction less the estimated cost of planned recycling and stabilisation.

Aside from introducing a new term “recyclable component” which is nowhere to be found in AASB116, this approach to cost allocation ignores the actual cost of the components and would result in a lower value being ascribed to the (short-life) recyclable component and a higher value to the (long-life) non-recyclable component with the result that annual depreciation expense is reduced.

2.2. Subjectivity and impracticality of further componentising and depreciating infrastructure assets

February 2015 Agenda paper 8.4 (M143) provides more useful insight into the staff deliberations viz:

paragraph 5 AASB staff are of the view that componentisation of parts into sub-parts is not limited to cases in that sub-parts are physically distinct. Accordingly, AASB staff continue to consider that recyclable and non-recyclable gravel could be componentised in order to accurately reflect the assets management strategy.

The NSW Local Government Auditors Association when considering infrastructure assets is understandably concerned by the need to obtain sufficient and appropriate audit evidence related, but not limited to:

- Asset valuation;
- Condition assessment;
- Componentisation;
- Useful lives;
- Depreciable amount;
- Depreciation methodology; and
- Impairment

In our experience when presented with a situation where a client has recognised a residual value it has been a relatively simple exercise to request that they demonstrate and provide evidence of how that residual value will be achieved through remediation. Of importance is that this approach does not require that the individual components or sub-components of an asset that give rise to a residual value are specifically identified.

An example might be provided by comparing the costs of impregnating existing sewer pipes with resin, with the cost of outright replacement. Prima facie, the difference in cost between the two is the value of the cavity provided by the failed pipeline. If the pipe has become permeable and deemed to be at the end of its useful life, none of the original elements of cost, the excavation, the bedding or the pipe itself have any remaining service potential. Only the cavity itself which will allow trenchless restoration of service potential has any value.

As we understand it, the application of view 1 would require componentisation of that cavity (quite literally a hole through the earth made of thin air) and depreciation over its useful life. We are concerned that meeting the requirements of AASB 13 to determine the fair value of the asset, AASB 116.50 to allocate the depreciable amount of the asset over its useful life and AASB 136.9 to annually review for indicators of impairment are but a few of many problems that arise when attempting to apply view 1 in practice.

The practical application of View 2 would require depreciation of the depreciable amount, being the cost of construction less the residual value (the cost savings arising from the salvage and re-use of materials in the construction of the replacement asset, net of costs of salvage).

Proper application of view 1 would also require significant addition to asset registers that already contain assets numbering in the tens-of-thousands. We believe this would essentially require the maintenance of a register for financial accounting purposes and a separate register for asset management purposes. We see this as a retrograde interpretation and one that works against many years of work to develop integrated asset registers.

For these reasons, we feel that application of view 1 in practice may in fact result in:

- difficulty in identifying the further components into which infrastructure assets will need to be broken;
- subjective and untestable assessments of useful life of “recyclable” assets – examples of 19th Century infrastructure that is still in use are surprisingly easy to find³ ⁴particularly in rural and regional areas and the useful life of modern “recyclable” assets may be far longer than those assets. Setting useful life estimates then becomes a best guess exercise.;
- poor application – the perception that standards are impractical, rooted in theory rather than common sense and require substantial work for questionable benefit result in uncommitted application; and
- less reliable financial information as a consequence of the above.

3. Recommendations

We were pleased to see the Board’s acknowledgement that adequate componentisation and estimation of useful lives would result in similar overall depreciation expense recognised under either view 1 or view 2. We share that view, but believe that view 2 is more easily understood, more readily applied, more reliable and not at all incompatible with the definition of residual value. Accordingly we propose that the AASB review its tentative agenda decision and:

1. - Determine there is sufficient latitude for a view 2 interpretation of the definition of residual value; or
2. - Amend the standard by insertion of an Aus paragraph to the effect that the definition of residual value recognises that “amount” may represent either a cash inflow from sale or a cost saving achieved from asset remediation.

³ <http://history.cityofsydney.nsw.gov.au/waterexhibition/images/zoom/tank2.jpg.html>

⁴ <http://www.scottbirdphotography.com/Local-History/Australias-Convict-Bridges/>