ABN 37 746 417 097

18 April 2015

Australian Accounting Standards Board
Level 7, 600 Bourke Street
MELBOURNE VIC 3000

Dear Sir/Madam,

Recognition of Residual Value for Infrastructure Assets – February 2015

Please find attached a submission by the South Australian Local Government Financial Management Group in regards to the proposed agenda decision on the recognition of residual values for infrastructure assets.

Regards,

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Submission by the South Australian Local Government Financial Management Group Inc - Recognition of Residual Values for Infrastructure Assets

Introduction

The South Australian Local Government Financial Management Group Inc (SALGFMG) represents financial management professionals in local government in South Australia. Membership of the SALGFMG is open to all councils and currently 60 of the 68 councils are members. The SALGFMG actively considers issues of relevance to local government financial management; works with the Local Government Association of South Australia and relevant State government entities to lobby on, advise on and improve the quality of financial management in local government in South Australia and regularly promotes best practice in financial management through newsletters, workshops and seminars.

The SALGFMG has reviewed the Tentative Agenda Decision issue by the Australian Accounting Standards Board (AASB) on February 23, 2015. It has also had the benefit of a presentation by two staff members of the AASB, Jim Paul and Evelyn Ling, which included discussion on the Tentative Agenda Decision.

The SALGFMG has also reviewed:

- the relevant paragraphs of AASB 116 and IAS 16;
- the Tasmanian Auditor-General's Report No. 4 of 2012-13, Volume 4 Part 1, Local Government Authorities 2011-12;
- the Tasmanian Auditor-General's Report No. 5 of 2013-14 – Infrastructure Financial Accounting in Local Government;
- the submission made by IPWEA in January 2015 to the AASB on the definition and use of residual value; and
- the submission made by APV in March 2015 to the AASB on the Tentative Agenda Decision.

Recommendation

The SALGFMG requests the AASB to reconsider its Tentative Agenda Decision to not add this issue to its work program on the basis that there remains uncertainty in some circumstances about accounting for the material from an asset that is reused in an item of property, plant or equipment:

- **in the value of the original item of property, plant or equipment; and**
- **in the value of the new item of property, plant or equipment.**

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Context

It has been the practice of local governments, among others, to classify the materials reused in the reconstruction of an asset as residual value and exclude the residual value from the depreciable amount of such assets. In commenting on this practice the Tasmanian Auditor-General in his Report No. 5 of 2013-14 – Infrastructure Financial Accounting in Local Government asserted that this practice was in contravention of the definition of residual value in AASB 116 which states that residual value is "…the estimated amount that an entity would currently obtain from disposal of the asset, after deducting the estimated costs of disposal, if the asset were already of the age and in the condition expected at the end of its useful life." In other words, the reuse of materials from an existing asset in the creation of a new asset does not fall within the definition of residual value.

The Auditor-General considered that the use of residual value had effectively been used to categorise part of an asset (its 'residual value') as having an infinite life and expressed concern that there was the potential for the asset to become obsolete and therefore incur an accelerated write-down of the residual value at some time in the future.

The Auditor-General had expressed in a previous report (Report No. 4 of 2012-13, Volume 4 Part 1, Local Government Authorities 2011-12) some concern that the use of residual value by councils had favourably skewed road consumption ratios.

The discussion in the February 2015 Tentative Agenda Decision of the AASB confirms the approach of the Tasmanian Auditor-General in that it makes clear that the current definition in AASB 116 of residual value relates to the consideration that would be received in disposing of an asset at the end of its useful life.

Further, the AASB considers that adequate componentisation of an item of property, plant or equipment will provide the correct depreciation expense, effectively suggesting that there will be a component that will not be depreciated or be depreciated to a significantly lesser extent that will provide the same (or very similar) depreciation expense than the current practice of using residual value in the case of the reuse of in-situ materials.

Infrastructure assets and asset management practices are not unique to local government and it is clearly important that accounting standards that relate to the recording and disclosure of financial information about infrastructure assets are uniform and consistent across sectors.

Is Increased Componentisation Sufficient?

The SALGFMG agrees that increased componentisation can provide a significantly more accurate depreciation expense based on better understood useful life determinations for the individual components of an item of property, plant or equipment.

However, there will still be situations where componentisation will not achieve the desired result. Consider the following two examples.

Example 1

Council ABC is a rural council with a significant length of gravelled roads servicing the transport needs of its community. A substantial portion of the road network comprises gravelled roads with a 200mm layer of gravel as the trafficable pavement. Council's asset management policy is to renew the gravel sheeting when the pavement layer falls to 40mm on average for a particular segment of road. Council considers that the top 160mm of the road is one component and the bottom 40mm of road is a separate component. The top component is depreciated in full over its useful life, which varies for different road segments depending on a range of factors including traffic volume, topography, quality of the gravel used in the road and climactic factors. The bottom component is not depreciated as it is considered that it will never be replaced. The Tasmanian Auditor-General's concern with obsolescence has some validity in regard to the bottom component but the likely date of the obsolescence of the bottom component is too uncertain to be given too much consideration, i.e. it is too difficult to forecast when there might be a technological change such that the nature of the road network will change.

Example 2

Council XYZ is an urban council with a significant portion of sealed roads servicing the transport needs of its community. Most of these roads are local roads and the pavement portion of the roads is reconstructed on a 60 year cycle. It is considered that the pavement would 'last' for 70 years, but Council also believes that allowing the pavement to degrade further may give rise to avoidable traffic incidents and also affect other components associated with the road to such an extent that the overall cost of the road network would be increased. In reconstructing the road after 60 years Council's experience has been that 25% of the materials within the existing pavement are reusable but there is not a definable layer of the pavement supplying the reused material. The current practice of Council is to apply a residual value of 25% of the value of the road-making material used in the existing pavement.

Example 1 is a good example of the use of better componentisation to achieve a more accurate depreciation expense.

Example 2 demonstrates that it is sometimes difficult to further componentise elements of an item of property, plant or equipment. Effectively, some of the road construction material used in the original asset has stood the test of time and is capable of being reused, but some of the road construction material has been 'used up' in providing the road pavement. There is no way to tell which piece of rubble will survive and which piece will be 'used up'.

If the whole of the pavement is depreciated over 60 years then the value of the reused road material will be an unnecessary impost on current ratepayers. Worse, under fair value principles the value of the material 'donated' by the entity to itself and used in a 'new' asset will, on the new asset's next revaluation, which will probably be in the next financial year, be recognised in the fair value of the new asset and depreciated a second (third, fourth,… time).

This poses the question if material from an asset is reused how do we account for it appropriately and equitably in the cost of the 'old' asset and the 'new' asset?

Further Clarification Required

The SALGFMG considers that the AASB needs to provide further guidance to entities on the issue of residual value. At the same time entities need to ensure that there is a genuine effort to accurately reflect in financial statements values associated with assets and sufficient evidence to support the values.

The SALGFMG considers there are three options available to deal with the issue of residual value for infrastructure assets. They are:

1. Redefine residual value – residual value could be redefined to include the expected value of materials likely to be reused in-situ. It is appreciated that this is not a simple solution as Australia's efforts to harmonise its accounting standards with international financial reporting standards mean that the current definition in AASB 116 mirrors that in International Accounting Standard 16.
2. Redefine componentisation – as indicated in Example 2, there may not be a physical, contiguous component but nevertheless there is material likely to be reused in-situ, which has a value for the 'old' item of property, plant or equipment and a value in a 'new' item of property, plant or equipment. Even though non-contiguous this could be defined as an allowable component.
3. Preserved value – adopt the terminology suggested by APV in their submission of March 2015 of preserved value to indicate a component of the item of property, plant or equipment that will be reused in the next incarnation of the item of property, plant or equipment. This is effectively the same as 2 above.

Each of these options requires entities to document and evidence their asset management policies and plans to support the values that will be included in financial statements.