

# **ACCOUNTING STANDARD AASB 116**

## **DEFINITION OF RESIDUAL VALUE**

**Further Submission by**

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# 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<sup>1</sup> 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.”

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



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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<sup>2</sup>:

- “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."**<sup>3</sup>

## 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."

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2. AASB 2014-1 Pt A made 4 June 2014.

3. AASB 116.6 Definitions



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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<sup>4</sup>. 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<sup>5</sup>.

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 getting 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 *residual 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.

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

5. AASB 116.7



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### “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<sup>6</sup>.

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

## 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<sup>8</sup>. 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.

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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.



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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”<sup>9</sup>; that “road earthwork assets that are assessed as not having a limited useful life shall not be depreciated”<sup>10</sup>; and that “the depreciation or non-depreciation of road earthwork assets shall be reviewed at the end of each accounting period”<sup>11</sup>.

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<sup>12</sup> - 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.

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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.



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### 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<sup>13</sup> 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.

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13. [http://www.aasb.gov.au/admin/file/content102/c3/Tentative\\_Agenda\\_Decision\\_February\\_2015.pdf](http://www.aasb.gov.au/admin/file/content102/c3/Tentative_Agenda_Decision_February_2015.pdf)



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### 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.

