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May 2022

Guidance paper - accounting for assets valued using current replacement cost

Objective of this guidance

This guidance has been prepared to assist entities account for assets recognised at fair value using the cost approach under AASB 13 *Fair Value Measurement*. The cost approach reflects the amount that would be required currently to replace the service capacity of an asset (often referred to as current replacement cost).

Important aspects to note under this approach include:

- substitute assets are of comparable utility
- obsolescence, encompasses adjusting for:
  - functional (technological) obsolescence
  - economic (external) obsolescence
  - physical deterioration.

Application of AASB 116 *Property, Plant and Equipment* to assets revalued using the cost approach

Under AASB 116 entities can chose to either adopt the 'gross' or 'net' disclosure methods in order to disclose information about the values for each asset class in the financial statements. Paragraph 35 of AASB 116 states:

> *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*
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> *(b) the accumulated depreciation is eliminated against the gross carrying amount of the asset.*

Departmental requirements

Under Treasurer's Instruction FR-3 *Format of Financial Statements*, all agencies listed in Column 1 of Schedule 1, Part 1 in the *Financial Management Act* 2016, unless otherwise exempted or provided for under the provisions of the Act, must prepare financial statements in accordance with the current *Model Departmental Financial Statements*, issued by the Department of Treasury and Finance. The *Model Departmental Financial Statements* specify for assets recognised under the revaluation model states:

> Departments should endeavour to obtain replacement cost valuations where possible to enable gross values to be disclosed. Where agencies do not have the information available to them for gross disclosures, they may continue to disclose revaluations on a net basis. Future revaluations should be undertaken on a gross basis where possible.

Gross disclosure method for revalued assets

As noted above, under the gross disclosure method:

- gross replacement cost is the amount determined in reference to observable market data before consideration of obsolescence. This must be the modern equivalent asset replacement cost, before any consideration of obsolescence or physical deterioration.
- accumulated depreciation is the difference between the gross replacement cost (gross carrying amount) and the current replacement cost (fair value) of the asset, after taking into account accumulated impairment losses.

As impairment losses are not recognised for not-for-profit entities for assets revalued under AASB 116 and AASB 138 *Intangible Assets*, accumulated impairment losses are nil and accumulated depreciation becomes the difference between the gross carrying amount (modern equivalent asset replacement cost) and the fair value amount.

Calculation of depreciation

Under AASB 116, depreciation is calculated by systematically allocating the depreciable amount of an asset over its useful life.

Depreciable amount of an asset

AASB 116 defines the depreciable amount of an assets as "*the cost of an asset, or other amount substituted for cost, less its residual value*."

AASB 116 does not define 'other amount substituted for cost', although this is commonly understood to be the fair value of an asset where the revaluation model is used after initial recognition at cost. Paragraph 31 of AASB 116, states:

> *… an item of property, plant and equipment whose fair value can be measured reliably shall be carried at a revalued amount, being its fair value at the date of the revaluation less any subsequent accumulated depreciation and subsequent accumulated impairment losses.*

AASB 116 does not contemplate the gross replacement cost being used as the 'amount substituted for cost'.

Determination of useful life

Useful life is defined in AASB 116 as:

> *(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.*

There is often confusion as to whether useful life represents the 'total useful life' of the asset to an entity or the 'remaining useful life' of the asset to an entity.

Our view is remaining useful life should be used. This is because:

- The revaluation model allows a revalued asset to be recognised on a 'net' basis where accumulated depreciation is eliminated against the gross carrying amount of the asset. In this case, the asset cannot be depreciated over its 'total useful life' as there is no gross carrying amount to use to determine the proportion of the life of the asset consumed to date.
- The concept of depreciation (obsolescence) under AASB 13 is different to that used in AASB 116, so it is unlikely accumulated depreciation, representing the difference between the gross replacement cost of the asset and its current replacement cost (fair value), would be equivalent to the amount of depreciation calculated under AASB 116 for its consumed life to date.
- The useful life of an asset is to be reviewed annually, with changes from previous estimates accounted for as a change in an accounting estimate in accordance with AASB 108 *Accounting Policies, Changes in Accounting Estimates and Errors* (AASB 116, paragraph 51).
- *The future economic benefits embodied in an asset are consumed by an entity principally through its use. However, other factors, such as technical or commercial obsolescence and wear and tear while an asset remains idle, often result in the diminution of the economic benefits that might have been obtained from the asset. Consequently, all the following factors are considered in determining the useful life of an asset:*
  - *expected usage of the asset. Usage is assessed by reference to the asset's expected capacity or physical output.*
  - *expected physical wear and tear, which depends on operational factors such as the number of shifts for which the asset is to be used and the repair and maintenance programme, and the care and maintenance of the asset while idle.*
  - *technical or commercial obsolescence arising from changes or improvements in production, or from a change in the market demand for the product or service output of the asset…*

- *legal or similar limits on the use of the asset, such as the expiry dates of related leases* (AASB 116, paragraph 56).

These factors are unlikely to remain static over the total useful life of the asset and can only be assessed on a prospective basis.

- Paragraph 57 of AASB 116 contemplates the useful life of an asset, defined in terms of its expected utility to the entity, may change over time, e.g. the entity may decide to sell the asset. The useful life of an asset may well be shorter than its economic life. Hence, the estimation of the useful life of the asset is a matter of judgement for the entity.

Calculating depreciation under the straight line method

The calculation of depreciation where the gross disclosure method is adopted is shown in the following example:

Example:

An asset is revalued using the current replacement cost approach as shown below:

	Gross Replacement Cost $	Utility %	Adjusted Cost $	Economic Life (years)	Useful Life (years)	Written Down Value $
Specialised building	89,600,000	75	67,200,000	50	15	20,160,000

Scenario A

The entity has determined the asset has no residual value and believes the asset has a useful life of 15 years. Annual depreciation is therefore $1,344,000 per annum for the next 15 years ($20,160,000 / 15 years). This reflects a depreciation rate of 1.5% based on the gross replacement cost of $89,600,000.

Scenario B

The entity has determined the asset has no residual value and believes the asset has a useful life of 20 years reflecting the period over which an asset is expected to be available for use by the entity. Annual depreciation is therefore $1,008,000 per annum for the next 20 years ($20,160,000 / 20 years). This reflects a depreciation rate of 1.125% based on the gross replacement cost of $89,600,000.

As can be seen from these scenarios, the original commissioning date and total useful life of the asset are irrelevant to the calculation of depreciation expense.