

Bruce Mackenzie
Chair
IFRS Interpretation Committee
Columbus Building
7 Westferry Circus
Canary Wharf, London E14 4HD
United Kingdom

Agenda Item Request: Determination of residual value (IAS 16)

Dear Mr Mackenzie,

The European Securities and Markets Authority (ESMA) is an independent EU Authority whose mission is to enhance the protection of investors and promote stable and well-functioning financial markets in the European Union (EU). ESMA achieves this aim by building a single rule book for EU financial markets and ensuring its consistent application across the EU. In the context of ESMA's supervisory convergence work in the area of financial reporting, I would like to raise with you an issue related to the application of IAS 16 *Property, Plant and Equipment*. ESMA has observed different views on the application of the requirements of IAS 16 in relation to the determination of residual value of an asset in scope of this standard.

Accordingly, ESMA kindly suggests that the IFRS Interpretations Committee (IFRS IC) considers clarifying the relevant accounting requirements. A detailed description of the case is set out in the appendix to this letter. We would be happy to further discuss this matter with you.

In case you have any questions or comments regarding this letter, please contact Isabelle Grauer-Gaynor, Head of the Corporate Finance and Reporting Unit (Isabelle.Grauer-Gaynor@esma.europa.eu).

Yours sincerely,

[signed]

Verena Ross

APPENDIX – DETAILED DESCRIPTION OF THE ISSUE

1 Description of the issue

1. The issue relates to the determination of residual value of leased assets by lessor when calculating the depreciation of these assets in accordance with requirements of paragraphs 43 et seq. of IAS 16.
2. The issue is illustrated using an example of an entity that manufactures cars and leases some newly produced vehicles to end customers, usually for a period of around three years (useful life), which is significantly shorter than the cars' economic life.
3. At the end of the lease term the cars are sold through different sales channels. Leased cars constitute a material part of the issuer's total assets. Due to their short useful life, even small changes in residual value have a significant impact on depreciation expenses and on subsequent profit from the sale of the cars.
4. The entity classifies the lease arrangements as operating leases and recognises the leased vehicles on the balance sheet at historical cost. It also applies requirements of paragraphs 84 and 85 of IFRS 16, according to which, depreciation of the vehicles is calculated in line with IAS 16 and subject to the impairment requirements in IAS 36.
5. Leased vehicles are depreciated on a straight-line basis over the lease term. The residual value at the end of the lease term is estimated at inception of the lease and is subsequently reviewed at least on an annual basis (paragraph 51 of IAS 16). Adjustments to the residual value are accounted for prospectively as a change in accounting estimate with future depreciation adjusted accordingly. In case a vehicle's residual value exceeds the carrying amount, depreciation is discontinued (paragraph 54 of IAS 16).
6. The entity determines residual value of a car by estimating the entity's disposal proceeds from the future sale of the car. The estimate is derived on a car-by-car basis mainly from a statistical model using various input factors including anticipated used car prices, projected trading volumes and macroeconomic trends.
7. ESMA notes that there are two views as to whether estimates regarding the future developments that are expected to occur during the remaining lease term, such as projected trading volumes of cars, macroeconomic trends and anticipated future used car prices should be reflected in the estimate of residual value:

View 1: Apart from the age and condition of a vehicle at the end of the lease, expectations regarding future developments should not be reflected in the estimation of the residual value

8. Proponents of View 1 understand the definition of residual value in paragraph 6 of IAS 16¹ literally and interpret the word ‘currently’ in that definition as referring to the current point in time, i.e. the balance sheet date.
9. They note that with the amendment to this definition in 2003, the IASB abandoned the previous definition of residual value², which was based on expected disposal proceeds. According to the rationale for the change in definition ‘the amended definition would require an entity to use current prices for assets of a similar age and condition to the estimated age and condition of the asset when it reaches the end of its useful life’³.
10. Moreover, paragraph BC29 of Basis for Conclusions on IAS 16 explains that the IASB changed the definition of residual value to the amount an entity could receive for the asset currently (at the financial reporting date) if the asset was already as old and worn as it will be when the entity expects to dispose of it.
11. According to View 1, since information regarding the future must not be factored into the estimate of residual value, the residual value shall be calculated as the expected disposal proceeds of a car at the balance sheet date (and not as the currently expected future disposal proceeds). This calculation considers the vehicle’s anticipated age and condition at the end of its useful life but not factors in expectations about future developments.

View 2: Expectations regarding future developments should be factored into the estimation of residual value

12. View 2 is based on a wider interpretation of the definition of residual value, proposing that future residual values must be estimated using currently observable information and current estimates.
13. Proponents of View 2 argue that depreciation expense is a typical example of an accounting estimate, as explicitly noted in paragraph 32(d) of IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors*. They point out, referencing paragraph 32 of IAS 8, that essential feature of such an estimate is that the amounts involved cannot be observed directly and must instead be estimated. In their opinion, this does not mean that estimates regarding the future should be disregarded, but instead the latest available, reliable information has to be used in order to develop the accounting estimate. This implies that the residual value needs to be determined through such judgements and assumptions.

¹ According to paragraph 6 of IAS 16, 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’.

² Before the amendment in 2003, the residual value of an asset was defined as ‘the net amount which the enterprise expects to obtain for an asset at the end of its useful life after deducting the expected costs of disposal’.

³ IASB, ED Proposed Improvements to IAS (2002), p. 125.

Therefore, estimates cannot represent the current disposal proceeds because, unlike what is suggested in paragraph 32 of IAS 8, these proceeds can be directly observed.

14. It is also argued that using disposal proceeds observable today when accounting for property, plant and equipment would not provide relevant information for users of financial statements and would conflict with the spirit and purpose of IAS 16. For example, if lower future residual values are almost certain due to policy changes (e.g. due to an already enacted future ban on combustion engines, tax increases etc.), View 1 would prevent depreciation of leased vehicles against almost certain facts and circumstances, which appears to be contrary to the intentions of the standard setter. Moreover, this would not result in information that is decision-useful for users of financial statements.
15. Furthermore, proponents of View 2 note that paragraph BC29 of the Basis for Conclusions on IAS 16 explains the need for change of the definition of residual value by stating that expectation of increases in an asset's value, because of inflation or otherwise, cannot override the need to depreciate it. This aligns with paragraph 54 of IAS 16, according to which depreciation is suspended in cases in which the residual value increases to an amount higher than an asset's carrying amount. However, the clarification provided in paragraph BC29 does not suggest that potential future decreases in residual value should similarly be ignored. The change appears to be focused solely on addressing future increases in residual value.
16. The following table illustrates the differences in the calculating the residual value according to **View 1** and **View 2**:

		View 1	View 2
Market prices for used cars	Current prices	✓	✓
	Future price trends	✗	✓
Trading volumes of new cars	Current trading volumes	✓	✓
	Future trading volumes	✗	✓
Macroeconomic environment	Current macroeconomic environment	✓	✓
	Macroeconomic trends	✗	✓

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17. ESMA seeks clarification on whether expectations about future developments such as projected trading volumes of cars, macroeconomic trends and anticipated future used car prices should be factored into the estimation of residual value calculated in accordance with paragraph 6 of IAS 16. ESMA notes that, given the wide use of residual values in industries such as the automotive, shipping and airline industries, it is likely that the issue raised is widespread and has material effect on those affected. Even though current prices often largely account for expected future developments, including regulatory changes and

consumer demand shifts, ESMA observes that estimations of future prices used under certain circumstances significantly differ from expected disposal proceeds at the balance sheet date.