Staff paper

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IFRS® Interpretations Committee meeting

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Topic	**Initial consideration**
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Introduction

1. The IFRS Interpretations Committee (Committee) received a submission about how an entity estimates the residual value of an item of property, plant and equipment (PP&E) applying IAS 16 *Property, Plant and Equipment*. Specifically, the submission asked whether an entity's estimate reflects expectations about future developments other than the expected age and condition of the item at the end of its useful life.

2. The objective of this paper is:

   (a) to provide the Committee with a summary of the matter;

   (b) to present our research and analysis; and

   (c) to ask the Committee whether it agrees with our conclusion that a standard-setting project is not needed to address the question and with our recommendation to publish a tentative agenda decision.

Structure

3. This paper includes:

   (a) background and summary of the matter (paragraphs 5–11);

(b) findings from the information request (paragraphs 12–20);

(c) staff analysis (paragraphs 21–33); and

(d) staff conclusion and recommendation (paragraphs 34–35).

4. There are three appendices to this paper:

(a) Appendix A—suggested wording of the tentative agenda decision;

(b) Appendix B—analysis of arguments for View 2; and

(c) Appendix C—submission.

Background and summary of the matter

Applicable requirements

5. Paragraph 6 of IAS 16 includes 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.

Summary of the matter

6. In the fact pattern described in the submission:

(a) an entity manufactures cars and leases them to its customers. The lease term is usually three years, which is significantly shorter than the cars' economic lives. The entity sells the leased cars at the end of the lease term.

(b) the entity classifies the lease contracts as operating leases and recognises the leased cars as property, plant and equipment. The entity measures the leased cars using the cost model in IAS 16 and depreciates them on a straight-line basis over the lease term. The leased cars constitute a large part of the entity's total assets.

7. In addition, as required by IFRS 16 *Leases* and IAS 16, the entity:

   (a) estimates residual values at the inception of the lease and subsequently reviews them at least annually;

   (b) accounts for changes to residual values prospectively by adjusting future depreciation in accordance with IAS 8 *Basis of Preparation of Financial Statements*;

   (c) stops depreciating the leased cars if their residual value exceeds their carrying amount; and

   (d) determines whether the leased cars are impaired and accounts for any identified impairment losses applying IAS 36 *Impairment of Assets*.

8. The submission asks whether the entity is required to reflect expected future developments, other than the expected age and condition of the asset at the end of its useful life, in its estimate of the residual value of leased cars. For simplicity, we refer to such developments as 'other expected future developments' in the rest of this paper. The submitter explains that, because the useful lives of the leased cars are significantly shorter than their economic lives, even small changes to the residual values of the leased cars have a material effect on depreciation expense and the subsequent profit from their sale.

9. The submission outlines two views:

   (a) *View 1—the residual value estimate should not reflect other expected future developments*: proponents of this view interpret the word 'currently' in the definition of residual value in IAS 16 (see paragraph 5 of this paper) as referring to the estimated disposal proceeds that would be obtained, *at the reporting date*, if the leased cars were already of the age and condition expected at the end of their useful life. Therefore, information about other expected future developments should not be reflected in the residual value estimate.

(b) *View 2—the residual value estimate should reflect other expected future developments:* proponents of this view interpret the definition of residual value more widely. They say that, in estimating residual value, an entity should:

(i) reflect the *future disposal proceeds* it expects to receive when it disposes of the leased cars at the end of their useful lives using all currently available information; and

(ii) not restrict its estimate to the disposal proceeds that would have been obtained at the reporting date based only on the age and condition expected at the end of the leased cars' useful lives.

10. The submission includes the following table illustrating different factors the submitter says would be reflected in an entity's estimate of residual value under each view:

		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	✖	✓

11. Appendix C reproduces the submission, which provides further background about the question and the views identified by the submitter.

Findings from the information request

Information request

12. We sent an information request to members of the International Forum of Accounting Standard Setters, securities regulators and large accounting firms. We also made the submission available on our website.

13. The request asked respondents to provide their input on the following questions:
    - (a) whether respondents have observed differences in how entities reflect other expected future developments in estimating the residual value of an item of PP&E.
    - (b) if they have observed such differences:
        - (i) whether these differences have (or could have) a material effect on the entities' financial statements;
        - (ii) whether these differences are present and similar across jurisdictions and industries, or are only present in particular jurisdictions or industries; and
        - (iii) what is the root cause of the differences.

14. We received 15 responses—seven from large accounting firms, seven from national standard-setters and one from an organisation representing a group of securities regulators. The responses received represent informal opinions and do not necessarily reflect the official views of those respondents or their organisations.

Summary of findings

Observed differences in accounting

15. Of the 15 respondents:

(a) seven respondents say they have not observed differences in the way entities reflect other expected future developments in estimating the residual value of an item of PP&E. These respondents say entities do not reflect these developments in that estimate (that is, they apply View 1).

(b) five respondents say they heard mixed views from the stakeholders they consulted. They say:

(i) most consulted stakeholders said they observed no differences in the way entities reflect other expected future developments and that entities apply View 1; and

(ii) a few consulted stakeholders said they observed differences in specific industries, with some entities reflecting other expected future developments in their estimates of the residual value of an item of PP&E and others not reflecting these developments in their estimates.

(c) three respondents say they observed differences in specific industries similar to those described in paragraph (b)(ii) above.

Industries, jurisdictions and materiality

16. Most respondents and consulted stakeholders who say they observed differences explain that those differences exist in the automobile manufacturing and vehicle leasing industries (vehicle-related industries). One respondent says the question in the submission is primarily relevant to those industries because of the 'importance' of second-hand markets for vehicles and the price volatility observed in those markets. A few respondents say similar questions might arise in other industries in which residual values for PP&E are significant.

17. One respondent provides a detailed explanation of how entities estimate residual values in practice. That respondent says:

    (a) residual values are often estimated to be nil in many industries and for many assets. For example, entities might expect that disposal proceeds might not exceed the cost of disposing of the assets.

    (b) residual values tend to be higher than nil for entities that have a policy or practice of replacing their assets on a predictable schedule, typically by selling the assets at the end of each replacement cycle. In those cases, entities usually determine residual values by reference to current market prices for similar assets, adjusted for age and condition expected at the end of the asset's useful life.

    (c) in industries in which residual values are particularly significant, entities might use more sophisticated residual value modelling techniques. These models use current market prices as a starting point, but entities might adjust model outputs for entity-specific or asset-specific assumptions. In vehicle-related industries, methodologies and assumptions vary depending on the nature of the fleet. For example:

        (i) for more established vehicle types, market prices are relatively stable, and entities make limited adjustments to model outputs.

        (ii) for newer vehicle types, such as electric vehicles, models may include additional assumptions to reflect factors expected to affect disposal amounts. These factors include expected technological developments (for example, battery technology), model changes, regulatory restrictions, market volatility or downward pricing trends.

    (d) in some cases, estimates may include inflation-related assumptions, although the respondent says entities are often cautious about including inflation assumptions in residual value estimates when applying IAS 16.

18. The respondents and consulted stakeholders who say they observed differences generally explain that those differences:

    (a) could have a material effect, particularly for entities whose assets have significant residual values (such as in vehicle-related industries); and

    (b) are not confined to specific jurisdictions.

Root causes

19. Some respondents say the root cause of the observed differences in accounting is the differing interpretations of the definition of residual value in IAS 16, as well as the limited requirements and guidance in IAS 16 about how to estimate residual value.

20. However, a few respondents say the root cause of the observed differences is practical and commercial factors. In particular:

    (a) one respondent says some entities use sophisticated residual value models for commercial purposes, such as for pricing leases and assessing lease profitability. Information from those models might indicate that current market prices do not reflect the amount the entity expects to obtain when it disposes of an asset. Entities that adjust for factors other than age and expected condition in estimating the residual values of assets might view those adjustments as reflecting the best information currently available, rather than as forecasting future price movements. Those entities might consider that, without such adjustments, residual values would be overstated.

    (b) another respondent provides an example of a situation in which current market prices were not representative of the values expected at the disposal date. The respondent says that, during the covid-19 pandemic, second-hand car prices increased due to supply chain issues. Although entities expected that increase in prices to be temporary, estimating residual value based on current prices (adjusted only for age and expected condition of the asset at the end of its useful life) resulted in higher residual values (and lower depreciation expense) in some periods, followed by decreases in residual values (and higher depreciation expense) in subsequent periods when prices normalised.

Staff analysis

Criteria for a standard-setting project

21. Paragraph 5.19 of the IFRS Foundation *Due Process Handbook* (*Handbook*) states that the Committee assesses the need for a standard-setting project based on whether:

    (a) the matter has widespread effect—that is:

        (i) the circumstance or transaction is prevalent, or is expected to be prevalent; and

        (ii) there is diversity, or expected diversity, in the application of IFRS Accounting Standards that has, or is expected to have, a material effect on those affected;

    (b) it is necessary to add or change requirements in IFRS Accounting Standards to improve financial reporting—that is, the principles and requirements in IFRS Accounting Standards do not provide an adequate basis for an entity to determine the required accounting;

    (c) the matter can be resolved efficiently within the confines of the existing Standards and the *Conceptual Framework for Financial Reporting*; and

    (d) the matter is sufficiently narrow in scope that the International Accounting Standards Board (IASB) or the Committee can address it efficiently, but not so narrow that it is not cost-effective for the IASB or the Committee and stakeholders to undertake the due process required to amend an IFRS Accounting Standard.

Does the matter have widespread effect? (paragraph 5.19(a))

22. The purpose of any information request we send to stakeholders is to understand whether a submission meets the criterion in paragraph 5.19(a) of the *Handbook*—that is, whether the matter set out in the submission has widespread effect. We consider:

    (a) the prevalence, or expected prevalence, of the transaction or fact pattern submitted; and

    (b) whether there is diversity, or expected diversity, in the application of IFRS Accounting Standards to that transaction or fact pattern that has, or is expected to have, a material effect on those affected.

23. In our view, the findings from our information request (summarised in paragraphs 15–20 of this paper) indicate that the matter described in the submission has widespread effect in vehicle-related industries. Many respondents either directly report observing differences in the way entities reflect other expected future developments in estimating the residual value of an item of PP&E, or report hearing from other stakeholders that they observed such differences. Therefore, in our view, the criterion in paragraph 5.19(a) of the *Handbook* is met.

Is it necessary to add to or change the Standards? (paragraph 5.19(b))

Analysis of the applicable requirements

Applying the definition of residual value

24. As set out in paragraph 5 of this paper, paragraph 6 of IAS 16 includes 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.

25. In our view, the definition explicitly requires an entity to estimate the amounts that it would *currently* obtain—that is, the amounts that would be obtained at the reporting date—if the asset were already of the age and in the condition expected at the end of its useful life.

Amendments to the definition of residual value

26. The current definition of residual value was introduced when the IASB revised IAS 16 in 2003, as part of a larger project to improve several IFRS Accounting Standards. The previous definition of residual value stated that:

> *Residual value* is 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.

27. Paragraph BC29 of the Basis for Conclusions on IAS 16 explains the IASB's decision to change the definition of residual value:

> The [IASB] decided to improve the previous version of IAS 16 by making clear the objective of deducting a residual value in determining an asset's depreciable amount. (…) Given the concept of depreciation as a cost allocation technique, the Board concluded that an entity's expectation of increases in an asset's value, because of inflation or otherwise, does not override the need to depreciate it. Thus, 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 were already as old and worn as it will be when the entity expects to dispose of it. Thus, an increase in the expected residual value of an asset because of past events will affect the depreciable amount;

> expectations of future changes in residual value other than the effects of expected wear and tear will not. [emphasis added]

28. In our view, the explanation above shows that the IASB deliberately changed the definition of residual value so that, instead of asking an entity to estimate the amount it *will* receive in the future (the amount an entity 'expects to obtain for an asset at the end of its useful life'), it requires the entity to estimate an amount it would currently obtain *at the reporting date*. The explanation also states that 'future changes in residual value other than the effects of expected wear and tear' do not affect an asset's residual value.

Future developments that affect current prices

29. The submission describes Views 1 and 2 in terms of whether the estimate of residual value should—or should not—reflect other expected future developments. However, we think neither of the two views outlined in the submission accurately describes how an entity would reflect these developments in estimating residual value applying IAS 16. In our view, an entity:

    (a) reflects other expected future developments to the extent they would affect the amount the entity would currently obtain for the asset *at the reporting date* (that is, to the extent they affect current prices). For example, expected future technological changes that might make an asset obsolete could affect the amount an entity would currently obtain for the asset at the reporting date.

    (b) does not reflect other expected future developments to the extent they would affect the amount the entity will obtain for the asset only in the future (that is, to the extent they affect only future prices). For example, inflation between the reporting date and the end of an asset's useful life might affect the amount an entity expects to obtain for the asset only in the future.

Why we disagree with View 2

30. The submission includes arguments from proponents of View 2. Appendix B includes our analysis of these arguments. That analysis does not change our analysis and views set out in paragraphs 24–29.

Conclusion

31. Based on our analysis in paragraphs 24–30, in our view:

    (a) the definition of residual value explicitly requires an entity to estimate the amount that it would *currently* obtain—that is, the amounts that it would obtain at the reporting date—from disposal of the asset if it were already of the age and in the condition expected at the end of its useful life. The entity does not estimate the amount it expects to obtain when it disposes of the asset in the future (that is, the entity does not estimate its expected future disposal proceeds).

    (b) an entity's estimate of the residual value of an asset reflects other expected future developments to the extent that these developments affect the amount the entity would currently obtain at the reporting date.

Question 1 for the Committee
1. Does the Committee agree with our analysis of the application of the requirements in IAS 16 summarised in paragraph 31 of this paper?

Is the criterion in paragraph 5.19(b) met?

32. Based on our analysis in paragraphs 24–30, and as summarised in paragraph 31, we think the principles and requirements in IAS 16 provide an adequate basis for an entity to determine whether to reflect expectations about future developments in estimating the residual value of an item of PP&E.

33. Accordingly, we conclude that the criterion in paragraph 5.19(b) of the *Handbook* is not met. Therefore, in accordance with paragraph 5.22 of the *Handbook*, a standard-setting project is not needed to address the question submitted.

Staff conclusion and recommendation

34. Based on our assessment of the criteria in paragraph 5.19 of the *Handbook*, we recommend that the Committee publish a tentative agenda decision explaining its decision that a standard-setting project is not needed. In accordance with paragraphs 8.2–8.3 of the *Handbook*, we also recommend that the tentative agenda decision explain how an entity determines whether to reflect other expected future developments in estimating the residual value of an item of PP&E.

35. Appendix A sets out the suggested wording of the tentative agenda decision. In our view, the suggested tentative agenda decision (including the explanatory material contained within it) would not add or change requirements in IFRS Accounting Standards.[1]

Questions for the Committee

Questions 2 and 3 for the Committee
2. Does the Committee agree with our conclusion that the criterion in paragraph 5.19(b) of the Handbook is not met and, consequently, there is no need for a standard-setting project?
3. Does the Committee have any comments on the wording of the tentative agenda decision suggested in Appendix A?

[1] Paragraph 8.4 of the *Due Process Handbook* states: 'Agenda decisions (including any explanatory material contained within them) cannot add or change requirements in IFRS Accounting Standards. Instead, explanatory material explains how the applicable principles and requirements in IFRS Accounting Standards apply to the transaction or fact pattern described in the agenda decision.'

Appendix A—Suggested wording of the tentative agenda decision

A1. We propose the following wording for the tentative agenda decision.

Estimating Residual Value (IAS 16 *Property, Plant and Equipment*)

The Committee received a request about how an entity estimates the residual value of an item of property, plant and equipment applying IAS 16 *Property, Plant and Equipment*. Specifically, the request asked whether an entity's estimate of residual value reflects expected future developments other than the expected age and condition of the item at the end of its useful life.

Fact pattern

In the fact pattern described in the request:

a. an entity manufactures cars and leases them to its customers. The lease term is usually three years, which is significantly shorter than the cars' economic lives. The entity sells the leased cars at the end of the lease term.

b. the entity classifies the lease contracts as operating leases and recognises the leased cars as property, plant and equipment. The entity measures the leased cars using the cost model in IAS 16 and depreciates them on a straight-line basis over the lease term.

The request asks whether the entity is required to reflect expected future developments, other than the expected age and condition of the leased cars at the end of their useful life, in its estimate of the leased cars' residual value.

Applying the requirements in IAS 16

Paragraph 6 of IAS 16 defines the residual value of an asset as '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.'

The Committee observed that the definition of residual value requires an entity to estimate the amount it would *currently* obtain—that is, the amount the entity would obtain at the reporting date—from disposing of the asset if it were already of the age and in the condition expected at the end of its useful life. In doing so, an entity would reflect expected future developments to the extent such developments affect the amount the entity would currently obtain from disposing of the asset at the reporting date.

Conclusion

The Committee concluded that the principles and requirements in IAS 16 provide an adequate basis for an entity to determine whether, in estimating the residual value of an item of property, plant and equipment, it should reflect expected future developments other than the item's expected age and condition at the end of its useful life. Consequently, the Committee [decided] that a standard-setting project is not needed to address the request.

Appendix B—Analysis of arguments for View 2

B1. The submission includes arguments from proponents of View 2. We analyse these arguments below.

Estimating residual value involves judgements and assumptions

B2. The submission states:

> 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. 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.

B3. We disagree with the argument reproduced in paragraph B2. We agree that an entity must estimate the residual value of an item of PP&E, and that it should use judgements and assumptions based on the latest available, reliable information in doing so. However, as explained in paragraphs 24–28 of this paper, an entity develops an estimate of the amount that it would *currently* obtain from disposal of the asset, not an estimate of the amounts it expects to obtain when it disposes of the asset *in the future*. An entity might, for example, use observable inputs in developing that estimate (such as prices in second-hand markets for vehicles) and adjust those prices to take into account the age and condition of the asset at the end of its useful life.

B4. In addition, we note that the requirements in IAS 8 do not affect how an entity measures an asset or a liability; rather, an entity applies the requirements in the applicable IFRS Accounting Standard in doing so. In this context, the requirements in IAS 8 affect only:

(a) whether an entity accounts for a change resulting from applying the applicable Standard as a change in an accounting estimate or as a change in accounting policy; and

(b) the disclosures an entity must provide for such a change.

Reflecting future developments provides more relevant information

B5. The submission states:

> 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.

B6. As mentioned in paragraph 29 of this paper, we think an entity's estimate of the amount it would currently obtain from disposal of an asset would reflect other expected future developments *to the extent* they would affect the amount the entity would currently obtain for the asset at the reporting date. We think expected policy changes, which could include policies that encourage or discourage the production of particular types of vehicles, are an example of such future developments.

Reasons for changing the definition of residual value

B7. The submission states:

> [P]roponents 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.

B8. We agree that paragraph BC29 of the Basis for Conclusions on IAS 16 (reproduced in paragraph 27 of this paper) explains that the IASB decided to change the definition of residual value to avoid situations in which expected increases in the asset's residual value would result in an entity ceasing to depreciate the asset. However, this explanation does not change the requirement for an entity to estimate the amount that it would *currently* obtain from the disposal of the asset, in accordance with the definition of residual value, even if an entity expects that such value might decrease in future periods.

B9. We also note that an entity is required to:

(a) review its estimate of the residual value of an asset at least at each financial year-end (as required by paragraph 51 of IAS 16). Therefore, an entity will regularly reflect the effects of other expected future developments in its estimates at each financial year-end (to the extent these developments affect the amount the entity would currently obtain at each year-end).

(b) apply IAS 36 to determine whether the asset is impaired (as required by paragraph 64 of IAS 16). Therefore, the asset's carrying amount will never be higher than its recoverable amount.

Appendix C—Submission

C1. We have reproduced the submission below.

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 16[2] 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 value[3], 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'[4].

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

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[2] 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'.

[3] 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'.

[4] IASB, ED Proposed Improvements to IAS (2002), p. 125.

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. 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	✖	✓

Request

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.