IAS 17: Calculation of the Implicit Interest Rate in a Lease

Extract, IFRS Discussion Group Report on Meeting – November 25, 2009

IAS 17 *Leases* includes guidance on the calculation of the implicit interest rate in a lease. Paragraph 4 of IAS 17 states: "The *interest rate implicit in the lease* is the discount rate that, at the inception of the lease, causes the aggregate present value of (a) the minimum lease payments and (b) the unguaranteed residual value to be equal to the sum of (i) the fair value of the leased asset and (ii) any initial direct costs of the lessor." For additional guidance on how the residual value should be determined, some entities refer to the guidance in IAS 16 *Property, Plant and Equipment.* Paragraph 29 of the Basis for Conclusions to IAS 16 stresses that the residual value is "the amount that an entity could receive for the asset currently (at the financial reporting date) if the asset were already as old and worn out as it will be at the time the entity expects to dispose of it." When inserting the residual value, determined in accordance with IAS 16, in the calculation of the implicit interest rate in IAS 17, some entities treat the residual value as if the value is already a present value. This has led to these entities treating the cash flow from the residual value as if it was received in the current period and not at the end of the lease term. Including the unguaranteed residual value as a current period cash flow, instead of as a cash flow at the end of the lease term, when determining the implicit interest rate of the minimum lease payments does not appear to reflect the economics of a leasing transaction. Several members observed that the residual value concept in IAS 16 is in relation to the amortization of assets, not the value of an asset at a point in time.

Some IDG members acknowledged that they could see how the standards were being read to arrive at the treatment described above. It was noted that the IFRIC will often try to resolve apparent conflicts between standards and provide guidance as to which standard should be applied when. Therefore, in this situation the IFRIC could be asked to respond to whether it is appropriate to apply the residual value concept in IAS 16, which was developed for purposes of determining amortization, to the calculation of implicit interest rates in IAS 17. IDG members noted that the IASB had amended the residual value concept in IAS 16 effective in 2005. AcSB staff agreed to undertake further research into whether, at the time of amending IAS 16, the IASB considered the effects of that amendment on IAS 17.

Source: www.frascanada.ca/ifrs-discussion-group