IFRS 16: Lessee's Discount Rate

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A lessee is required to initially measure the lease liability at the present value of the lease payments. Paragraph 26 of IFRS 16 *Leases* states, in part, the following:

> "The lease payments shall be discounted using the interest rate implicit in the lease, if that rate can be readily determined. If that rate cannot be readily determined, the lessee shall use the lessee's incremental borrowing rate."

A lessee's incremental borrowing rate is defined as follows:

> "The rate of interest that a lessee would have to pay to borrow over a similar term, and with a similar security, the funds necessary to obtain an asset of a similar value to the right-of-use asset in a similar economic environment."

Paragraphs BC160 to BC162 in the Basis for Conclusions on IFRS 16 provides additional guidance on the lessee's discount rate.

Fact Pattern 1

- Entity A is a start-up entity and has never borrowed funds to operate other than in the form of convertible debentures. The interest rate used to determine the initial fair value of the liability component has been between 15 per cent and 30 per cent depending on the term of the debentures and whether the debentures are secured.
- On January 1, 2019, Entity A enters into a five-year contract to lease office space in a large office building with many tenants. The lease has a two-year extension option that Entity A concludes it is not reasonably certain to exercise at the commencement date of the lease. The potential amounts to be recognized for the right-of-use asset and the lease liability are significant to Entity A. The interest rate implicit in the lease cannot be readily determined by Entity A.
- On January 1, 2023, due to a change in facts and circumstances, Entity A has decided it is now reasonably certain to exercise the extension option.

Issue 1: How should Entity A determine its incremental borrowing rate on the commencement date of the lease?

Analysis

Paragraph 26 of IFRS 16 is clear that a lessee must use its incremental borrowing rate if the interest rate implicit in the lease is not readily determinable. This requirement is applicable for Entity A even if there are other entities leasing office space in the same building that use a lower discount rate.

Entity A needs to determine its incremental borrowing rate by taking into account its credit standing, the length of the lease, the nature and quality of the collateral provided and the economic environment in which it operates and leases office space. This approach does not necessarily mean that Entity A’s discount rate will be the same as that of its debt host in the convertible debenture. Rather, all facts and circumstances, including the existence of security in the underlying property, needs to be considered. Such an analysis may result in a lower discount rate attributed to the lease liability than to a convertible debt of a similar amount.

The above analysis would also be applicable to a start-up entity that has never borrowed funds before and only financed its operations through the equity it raised.

The Group’s Discussion

Group members agreed with the above analysis.

The Group further discussed whether market rental rates for real estate that are easily observable could be used as a proxy for the incremental borrowing rate. Group members noted that market rental rates might not reflect the lessee’s own credit risk that is inherent in the lessee’s specific lease arrangement. The lessee’s own credit risk is required to be reflected in the determination of its incremental borrowing rate for that lease. Therefore, the measurement of the lease liability will be affected by the lessee’s own credit risk inherent in the lessee’s specific lease arrangement regardless of whether the discount rate is based on the lessor’s implicit lease rate or the lessee’s incremental borrowing rate.

The Group also observed that the level of effort to determine the incremental borrowing rate could be significant, especially for entities with a significant portfolio of leases.

Issue 2: What discount rate should Entity A use when it exercises a renewal option not previously included in the lease term?

Analysis

Paragraph 40(a) of IFRS 16 indicates that a lessee shall remeasure the lease liability by discounting the revised lease payments using a revised discount rate if there is a change in the lease term.

Paragraph 41 of IFRS 16 then states the following:

> “In applying paragraph 40, a lessee shall determine the revised discount rate as the interest rate implicit in the lease for the remainder of the lease term, if that rate can be readily determined, or the lessee's incremental borrowing rate at the date of reassessment, if the interest rate implicit in the lease cannot be readily determined.”

Therefore, on January 1, 2023, Entity A will estimate its incremental borrowing rate for the remaining three-year lease term using the same approach described under Issue 1, except that it will take into account any new facts and circumstances since the initial lease was signed.

The Group’s Discussion

Group members agreed with the above analysis.

Fact Pattern 2

- The facts and circumstances are the same as Fact Pattern 1, except that Entity A enters into the lease on January 1, 2018 and transitions to IFRS 16 on January 1, 2019.
- Furthermore, the lease is with another entity in a related party group and is on market terms. Entity A is able to determine the interest rate implicit in the lease.

Issue 3: When an entity applies paragraph C8(a) of IFRS 16, does it have the choice to use either its incremental borrowing rate or the interest rate implicit in the lease?

When an entity elects to apply IFRS 16 retrospectively with the cumulative effect of initially applying the standard recognized at the date of initial application, paragraph C8(a) of IFRS 16 applies. This paragraph requires a lessee to recognize and measure the lease liability on the date of application using the lessee's incremental borrowing rate at that date. There is no mention of whether an entity can use the interest rate implicit in the lease.

The two views are as follows:

- *View 3A – No, a lessee should use its incremental borrowing rate.*
- *View 3B – Yes, an entity can elect to use either its incremental borrowing rate or the interest rate implicit in the lease.*

The Group's Discussion

Group members supported the view that the lessee should use its incremental borrowing rate (View 3A). Paragraph C8(a) of IFRS 16 is applicable only when an entity elects to apply the standard retrospectively in accordance with paragraph C5(b) of IFRS 16. The transition guidance provides a practical expedient to avoid the challenges of determining the interest rate implicit in the lease as it would involve the use of hindsight.

Issue 4: When an entity applies paragraph C8(a) of IFRS 16, should the interest rate used reflect the original term of the lease or the remaining term of the lease as at the date of initial application?

Paragraph C8(a) of IFRS 16 does not specify whether the interest rate used should reflect the original term of the lease or the remaining term of the lease.

The two views are as follows:

- *View 4A – The discount rate should reflect the remaining term of the lease.*
- *View 4B – An entity can elect an accounting policy choice, applied consistently at the date of initial application of IFRS 16, to use either a discount rate which reflects the remaining term of the lease or the original lease term.*

The Group's Discussion

Group members agreed that the transition guidance in IFRS 16 does not address whether the interest rate used should reflect the original term of the lease or the remaining term of the lease on initial application under paragraph C8(a) of IFRS 16. One Group member noted that an entity could make an accounting policy choice in this area, which would appear to be consistent with one of the U.S. accounting firms' interpretation of U.S. GAAP (View 4B).

Nevertheless, most Group members agreed that the purpose of the transition guidance is to alleviate practical challenges, including the use of hindsight. Therefore, it would be consistent and practical for the discount rate to reflect the remaining term of the lease as at the date of initial application (View 4A).

One Group member clarified that if the original lease term was used, the discount rate should reflect the market conditions at the date of initial application.

Overall, the Group's discussion raises awareness about the determination of the lessee's discount rate when measuring a lease liability. No further action was recommended to the AcSB.

(For a full understanding of the discussions and views expressed, listen to the audio clip).