IFRS 16: Lessee’s Discount Rate

Extract, IFRS® Discussion Group Report on the Meeting – October 16, 2018

At its January 2018 meeting, the Group discussed whether an entity should use an interest rate that reflects the original term of the lease, or the remaining term of the lease, at the date of initial application when applying paragraph C8(a) of IFRS 16 *Leases* to measure the lease liability. The Group agreed that the transition guidance in IFRS 16 does not explicitly address this point.

At this meeting, the Group first discussed a related transition question with respect to measuring the right-of-use asset (Issue 1).

Issue 1: An entity has elected to measure the right-of-use asset by applying paragraph C8(b)(i) of IFRS 16. Upon initial adoption of IFRS 16, should the lessee measure the right-of-use asset using the same incremental borrowing rate that was used to measure the lease liability? Alternatively, can the lessee choose to use a rate reflective of the original lease term, even if it measured the lease liability using the remaining lease term?

Paragraph C8(b)(i) of IFRS 16 provides guidance on the recognition of a right-of-use asset at the date of initial application for leases previously classified as an operating lease under IAS 17 *Leases.* The paragraph allows a lessee to measure the right-of-use asset at “its carrying amount as if the Standard has been applied since the commencement date, but discounted using the lessee’s incremental borrowing rate at the date of initial application.”

View 1A – The right-of-use asset and lease liability should be measured using the same incremental borrowing rate.

Proponents of this view note that both paragraphs C8(a) and C8(b)(i) of IFRS 16 have identical terminology when referring to discounting using the lessee’s incremental borrowing rate at the date of initial application. Therefore, the same rate should be applied both to discounting the lease liability and the right-of-use asset.

Another consideration is that IFRS 16 intends for a single discount rate to be used for a new lease entered into subsequent to transition. If the right-of-use asset was measured independently from the lease liability, anomalous results would be produced.

View 1B – The right-of-use asset and lease liability may be measured using an incremental borrowing rate reflective of different lease terms.

Proponents of this view note that paragraph C8(b) of IFRS 16 states that the lessee shall choose, “on a lease-by-lease basis”, between the two options to measure the right-of-use asset. The availability of such a choice supports the view that a consistent approach is not needed when determining the incremental borrowing rate to be applied to the lease liability and the right-of-use asset.

The lease payments included in each of the options provided in paragraph C8(b) of IFRS 16 can be viewed as a better indicator of the term to consider when determining the incremental borrowing rate. Furthermore, paragraph C8(b)(i) of IFRS 16 refers to measuring the right-of-use asset "as if the Standard had been applied since the commencement date," which implies that the lease payments for the original lease term will be included. It seems inconsistent to then discount these cash flows using a rate that is reflective of the remaining lease term.

The Group's Discussion

Group members supported that the right-of-use asset and lease liability should be measured using the same incremental borrowing rate based on what is described in View 1A. The foundation of IFRS 16 requires consistency in measuring the right-of-use asset and lease liability.

The Group then discussed other considerations an entity should take into account when determining its incremental borrowing rate (Issue 2). The following are three sub-issues under this area which the Group considered together.

Issue 2.1: Can a lessee use the rate on its existing borrowings as its incremental borrowing rate?

Analysis

IFRS 16 defines a lessee's incremental borrowing rate as "[t]he 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."

As a result, there are many factors to consider in determining the lessee's incremental borrowing rate (e.g., credit quality, term and payment pattern, the security including collateralization by the underlying right-of-use asset, the borrowing rate to obtain an asset of similar value, and the economic environment).

The incremental borrowing rate must take into account the terms and conditions of the specific lease contract. Therefore, the lessee's rate on its existing borrowings may be a starting point, but it is likely adjustments will need to be made.

The following are some factors to consider when determining the need for an adjustment to the existing borrowing rates:

- The entity entered into its borrowings at a different point in time compared to the specific lease contract.
- The lessee's indebtedness level may change from entering into a new lease that would affect the rate at which the entity can borrow going forward.
- Yields on existing borrowings or credit facilities may not reflect a similar term as the specific lease contract, or reflect similar security compared with the lease arrangement where only the right-of-use asset may be used as collateral.
- Existing borrowings might contain embedded put or call options which affect the coupon rate.

Issue 2.2: May a subsidiary use its parent's incremental borrowing rate?

Analysis

A group of entities may have a centralized treasury function that the parent entity maintains. The subsidiary may not have its own external borrowings but it cannot default to using its parent entity's incremental borrowing rate because IFRS 16 requires the incremental borrowing rate to be specific to the lessee. Instead, the parent entity's incremental borrowing rate could be a starting point, but adjusted to reflect any differences in the subsidiary's credit profile. Such adjustments may be mitigated if there is a parent guarantee in place of the subsidiary's lease payments.

A foreign subsidiary needs to consider its economic environment, including whether its leases are denominated in a different currency. Also, a subsidiary may borrow from its parent at an intra-group rate. An adjustment may be required if the intra-group rate does not reflect market rates based on the subsidiary's credit profile.

In addition, considerations for other adjustments to the rate are similar to those described in Issue 2.1.

Issue 2.3: As stated in the definition of the incremental borrowing rate, how should a lessee interpret the phrase "pay to borrow over a similar term" when determining the appropriate incremental borrowing rate?

Analysis

Although IFRS 16 is not explicit as to how the phrase "similar term" should be interpreted, the duration over which the payments are made and the frequency of payments should be considered to achieve an incremental borrowing rate truly reflective of lease-specific characteristics.

The risks associated with an arrangement with frequent periodic payments of principal and interest (i.e., amortizing loan) are different from arrangements with a single principal payment at maturity (i.e., non-amortizing loan). Holding all other factors constant, a rate for a loan with repayment of principal only at maturity will often be higher than one that assumes monthly principal and interest payments throughout the duration of the loan. Therefore, this determination could have a significant impact on the measurement of the lease liability and right-of-use asset.

The Group's Discussion

Several Group members shared insights and experiences relating to Issues 2.1 to 2.3.

For a situation in which the lessee is a subsidiary and there is a centralized treasury function, the challenge is to adjust the corporate borrowing rate to a lessee and asset specific rate. Generally, this process would involve discussions with the treasury department to come up with a rate that is supportable and auditable. This process could result in identifying a range of reasonable rates and entities would need to apply judgment to determine which rate is most appropriate for the specific lease contract. It is also important to assess holistically whether all the adjustments made to the corporate borrowing rate are reasonable. One way of doing so could be looking at the rates in recently signed lease contracts to see if they align with the adjusted borrowing rate.

Group members also noted there are other factors that could affect the type of adjustments needed to a lessee's rate on its existing borrowings. For example, an entity needs to take into account the length of the lease, the nature and quality of the collateral provided and the economic environment in which the lease contract originates. These factors can be different when compared to existing borrowing arrangements of the entity. Further, some entities like smaller reporting issuers may not have other borrowings outstanding to use as a point of reference.

Although IFRS 16 is clear that the lessee's incremental borrowing rate must take into account the terms and conditions of the specific lease contract, a level of aggregation may be required to practically implement the standard. An analogy was made to determining different depreciation rates for categories of property, plant and equipment. Also, depending on the magnitude of the leases, there could be significant judgments involved in deciding the appropriate adjustments to a lessee's existing borrowing rate. As a result, an entity should consider whether it has provided adequate disclosures for financial statement users to understand the significant judgments applied in coming up with a reasonable incremental borrowing rate that is specific to a material lease, or group of material leases.

Overall, the Group's discussion raises awareness around what entities should consider when determining the incremental borrowing rate. No further recommendation was made to the AcSB.

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