



Project

Leases

Topic

Determination of the Discount Rate in a Lease

Objective

1. The purpose of this memorandum is to analyze how lessees and lessors should determine the discount rate to use to initially measure lease payments at present value. A separate memorandum will address whether the discount rate should be adjusted in subsequent periods and what disclosures should be required relating to discount rates.
2. This paper is structured as follows:
 - (a) Summary of staff recommendations
 - (b) Summary of the proposals in the *Leases* Exposure Draft (ED)
 - (c) Summary of feedback including comment letters and other outreach
 - (d) Staff analysis
 - (e) Appendix A – other matters relating to discount rates
 - (f) Appendix B – preliminary draft wording relating to determination of the discount rate to use to initially measure lease payments.

Summary of staff recommendations

3. The staff recommends that a lessee establish its discount rate as defined in the ED. That is, a lessee would use either:

This paper has been prepared by the technical staff of the IFRS Foundation and the FASB for discussion at a public meeting of the FASB or the IASB.

The views expressed in this paper are those of the staff preparing the paper. They do not purport to represent the views of any individual members of the FASB or the IASB.

Comments made in relation to the application of U.S. GAAP or IFRSs do not purport to be acceptable or unacceptable application of U.S. GAAP or IFRSs.

The tentative decisions made by the FASB or the IASB at public meetings are reported in FASB *Action Alert* or in IASB *Update*. Official pronouncements of the FASB or the IASB are published only after each board has completed its full due process, including appropriate public consultation and formal voting procedures

- (a) Its incremental borrowing rate; or
 - (b) The rate that the lessor charges the lessee (the rate implicit in the lease), if readily determinable.
4. Additionally, the staff recommends that the lessee guidance be clarified that if both rates are available, the lessee is required to use the rate the lessor charges the lessee.
 5. The staff recommends that the lessor should establish its discount rate as defined in the ED. That is, a lessor should use the rate that the lessor charges the lessee, which could be the lessee's incremental borrowing rate, the rate implicit in the lease, or, for property leases, the yield on the property.
 6. Additionally, the staff recommends that the definition of the rate that the lessor charges the lessee be clarified to state that when more than one indicator of the rate the lessor charges in the lease is available, the rate implicit in the lease should be used.

Summary of the proposals in the *Leases Exposure Draft (ED)*

7. Under the proposals in the ED, at the date of inception of the lease, a lessee should measure the liability to make lease payments at the present value of those payments, discounted using the lessee's incremental borrowing rate or, if it can be readily determined, the rate the lessor charges the lessee.
8. The ED proposes that the discount rate used to determine the present value of lease payments for all lessors is the rate that the lessor charges the lessee. That rate could be, for example the lessee's incremental borrowing rate, the rate implicit in the lease (defined as the rate that causes the sum of the present value of lease payments and the present value of the residual value of the underlying asset at the end of the lease to equal the fair value of the underlying asset), or, for property leases, the yield on the property.

9. Both the lessee's incremental borrowing rate and the rate that the lessor charges the lessee would reflect the nature of the transaction and the specific terms of the lease, such as lease payments, lease term, expected contingent rentals, expected payments under term option penalties and residual value guarantees, the expected value of the underlying asset at the end of the lease term, and any security attached to the underlying asset during and at the end of the lease term.

Summary of feedback including comment letters and other outreach

10. Some respondents, including those we met with during our outreach and a significant number of workshop participants, requested clarification of which rate should be applied when multiple discount rates are available to lessees and lessors:
 - (a) Should the lessee always use the rate the lessor charges the lessee if it is readily determinable?
 - (b) Should the lessor always use the implicit rate if it is readily determinable?
11. Many of these respondents also identified concerns with the proposals for lessees to apply their incremental borrowing rate to present value the liability to make lease payments when the rate the lessor charges the lessee cannot be readily determined. Those concerns included the following:
 - (a) the use of a lessee's incremental borrowing rate would reduce comparability amongst entities, and that decrease in comparability would be exacerbated by subjectivity in the measurement of substantial future lease payments (due to variable lease payments and payments due under periods covered by options to extend); and
 - (b) it may not be appropriate to assume that an acquisition of the underlying asset will always be fully financed with debt, rather than with a combination of debt and equity.
12. A few respondents identified other matters with determining the lessee's incremental borrowing rate in certain situations, for example, when:

- (a) credit curves are unavailable (for example, private companies that apply U.S. GAAP) or not relevant (for example, credit risk is not a significant factor in lease pricing for contracts such as a short-term car rental arrangement) including requests to use an alternative discount rate (non-recourse rate or weighted average cost of capital);
- (b) significant lease renewal options exist;
- (c) financing may not be available if the lease is for a relatively small proportion of the economic life of the underlying asset or for a low value underlying asset;
- (d) the lease is in a subsidiary entity and a group conducts all of its financing at a consolidated group/corporate level; or
- (e) determining the 'yield on property' (for example, for lessees of commercial real estate).

User feedback

- 13. Users were concerned that the use of a rate other than a readily available rate would result in a lack of comparability. That is because lessees with identical lease contracts and identical credit ratings may apply different discount rates and consequently may recognize different amounts as their liability to make lease payments.
- 14. Users also observed that, for an identical lease contract, a lessee with a lower credit rating would record a lower obligation to make lease payments than a lessee with a higher credit rating.
- 15. Users also requested greater visibility through disclosure of the discount rates applied, specifically by lessees, in measuring lease assets and lease liabilities.

Private company feedback

- 16. Private companies and not-for-profits were concerned with the costs of estimating an incremental borrowing rate, especially when such entities do not currently have debt with comparable terms as their lease portfolio. That is, leasing is their only source of long-term financing. Private companies also

pointed out that many of them are solely or largely funded by owner's equity and as a result would incur additional costs solely to comply with the standard.

Staff analysis

17. The staff thinks that the feedback on the determination of a discount rate indicated that most constituents agreed with the ED's proposals. However, the feedback received made it clear that constituents would like to have more application guidance in the areas noted.

Which rate to be used when multiple discount rates are available

Lessees

18. Some constituents pointed out that it was unclear if, in a lease in which the lessee knows the rate the lessor is charging, the lessee is required to use that rate or if it has the option to use its incremental borrowing rate.
19. In current guidance, a lessee may use the implicit rate instead of the incremental borrowing rate as follows:
 - (a) In IAS 17, a lessee must use the implicit rate in the lease if it is readily determinable.
 - (b) In Topic 840 *Leases*, the implicit rate in the lease may be used when determinable, so long as that rate is not higher than the incremental borrowing rate. That requirement in existing guidance reflects that a lessee would not agree to pay the rate the lessor is charging if it has an alternative source of borrowing that is less expensive.
20. The staff agrees that existing guidance in IFRSs should be carried forward. That is, the lessee should use the rate the lessor charges the lessee when it is readily determinable.
21. The staff does not think that the proposals in the ED need to be changed to reflect the requirement in current U.S. GAAP, whereby a lessee should use the implicit rate, even when readily determinable, only when it is lower than the lessee's incremental borrowing rate. The staff notes that, under current

guidance, that requirement affects lease classification, but only affects lease measurement when the lease is determined to be a capital lease. A capital lease is economically closer to a purchase of the underlying asset than an operating lease. That means that a lessee should not use an implicit rate that is higher than its incremental borrowing rate because if the incremental borrowing rate is the less expensive option, the lessee would choose to finance the purchase of the underlying asset through debt rather than through a capital lease.

22. However, under a right-of-use model, the measurement of all leases will be affected by the discount rate selected. In many leases that are presently considered to be operating leases, the lease transaction may not be considered to be similar to the acquisition of the underlying asset through debt. As a result, the implicit rate can be much higher than a lessee's incremental borrowing rate because it includes a premium that the lessee is willing to pay for the convenience of leasing the underlying asset. That is especially true with shorter-term leases. The staff thinks that if an implicit rate is readily determinable, a lessee should be required to use that rate, even when it is higher than the lessee's incremental borrowing rate.

Definition of the rate the lessor charges the lessee

23. Some constituents pointed out that it was unclear, when multiple indicators of the rate that the lessor charges the lessee (for example, the lessee's incremental borrowing rate, the rate implicit in the lease, or, for property leases, the yield on the property) are available, which indicator should be applied.
24. The staff identify that both current IFRSs and U.S. GAAP apply the definition of 'implicit rate in the lease' in determining the discount rate that should be applied when accounting for leases. The staff did not identify any significant concerns in the feedback received on the ED relating to application of the rate implicit in the lease as the primary indicator of the rate that the lessor charges the lessee.
25. Therefore, the staff recommends that the definition of the rate that the lessor charges the lessee be clarified to state that when more than one indicator of the rate the lessor charges in the lease is available the rate implicit in the lease should be used.

Staff recommendation

26. The staff recommend carrying forward the ED proposals with an additional clarification that when multiple rates are available to the lessee and to the lessor that the implicit rate in the lease should be used to discount the liability to make lease payments. The draft wording of the staff recommendation is in Appendix B.

Question 1

The staff recommends that:

- (a) lessees should use the incremental borrowing rate or the rate the lessor charges the lessee if readily determinable. If both rates are available, the lessee should use the rate the lessor charges in the lease.
- (b) lessors should use the rate charged in the lease.
- (c) the definition of the rate that the lessor charges the lessee should be clarified to state that when more than one indicator of the rate the lessor charges in the lease is available, the rate implicit in the lease should be used.

Do the Boards agree, why or why not?

Application of alternative discount rates

27. Appendix A discusses feedback received that alternative discount rates other than those proposed in the ED should be used by lessors and lessees. These include:
- (a) Using an alternative discount rate (for example, a non-recourse rate or weighted average cost of capital (WACC)); and
 - (b) Using a risk-free rate in leases where credit risk is not a factor in pricing.
28. The staff do not support these suggestions because of a concern of the lack of comparability that may arise if lessees, and to a lesser extent lessors, are able to apply a greater range of discount rates than proposed in the ED.

29. Instead, the staff thinks that these suggestions of applying alternative discount rates should be addressed through additional application guidance in the final leases standard, rather than by changing the requirements in the ED.
30. The staff also thinks that further consideration of some of these concerns may be appropriate if the Boards decide to identify two types of leases because the staff thinks that some of these concerns are particularly applicable to applying a discount rate to liabilities to make lease payments for other-than-finance leases.

Application guidance relating to use of the discount rates proposed in the ED

31. Appendix A also discusses several other matters raised regarding application of discount rates to measure lease payments. Many of these matters are identified above in paragraphs 11 and 12 and relate to how to apply the discount rates proposed in the ED to specific circumstances. These matters include:
 - (a) Concerns with using the incremental borrowing rate when there are options to extend or terminate a lease;
 - (b) Use of a group rate when financing normally occurs above the level of the lessee entity; and
 - (c) Determining the yield on a property.
32. The staff acknowledges the concerns identified relating to applying the discount rates described in the ED and recommends that additional application guidance is provided in the final leases standard.

Question 2

The staff recommends that additional application guidance should be provided in the final leases standard on how to apply the discount rate to specific circumstances.

Do the Boards agree, why or why not?

Disclosure and reassessment

33. At a future date, the staff will present memos discussing:
- (a) disclosures for leases, including disclosures regarding discount rates, to the boards. Possible disclosures include the discount rate used (for a lessee, disaggregated by leases that are discounted using an incremental borrowing rate versus those using the rate that the lessor is charging) and the method used in determining the discount rate; and
 - (b) reassessment of the discount rate and whether the subsequent measurement of lease payments should reflect any subsequent changes in the discount rate (for example, when there is a change in an entity's estimate of the lease term).

Appendix A – Other matters relating to discount rates

Application of alternative discount rates

Nonrecourse rate

- A1. Some constituents stated that it may be appropriate to use an incremental borrowing rate that reflects the nonrecourse nature of a lease arrangement:

It is unclear in the proposed guidance whether the incremental borrowing rate should be the lessee's incremental borrowing rate for general corporate purposes or a non-recourse (i.e., asset specific) rate. (CL #315)

- A2. Not all leases are nonrecourse in nature. That is, the degree to which the leased asset acts as security for the lessor will vary from lease to lease. The staff notes that the definition of incremental borrowing rate already incorporates the level of security that the underlying asset provides the lessee.
- A3. The staff recommends that the definition of incremental borrowing rate not be modified to further highlight that the rate should incorporate the degree to which the lease is nonrecourse.

Weighted average cost of capital

- A4. Many constituents suggest that it would be appropriate for the lessee to discount lease payments using the lessee's weighted average cost of capital (WACC) because:
- (a) The boards have proposed the use of the lessee's incremental borrowing rate, which assumes the borrowing of funds is equivalent to the purchase of the underlying asset. The purchase of an underlying asset usually occurs through a combination of debt and equity funding, which is consistent with the concept of WACC.
 - (b) Using WACC is more consistent with the discount rate that would be applied in performing an impairment test of the right-of-use asset.
 - (c) It may be a more appropriate rate to use WACC when financing would not be available to purchase the underlying asset in a lease, for example if the lease is for a relatively small proportion of the

economic life of the underlying asset or for a low-value underlying asset.

(d) For preparers, it may be simpler to calculate.

- A5. However, the staff notes that WACC is a portfolio-level discount rate. Using a more asset-specific rate, such as the implicit rate in the lease or the lessee's incremental borrowing rate, recognizes that lease contracts are priced in consideration of the specific underlying assets subject to the lease.
- A6. The staff does not recommend that the definition of the discount rate to be applied to discount lease payments be modified to allow for the use of a WACC.

Using a risk-free rate in leases in which credit risk is not a factor in pricing

- A7. Some constituents pointed out that requiring the use of the incremental borrowing rate, especially in leases in which the pricing of the lease is not significantly dependent on the lessee creditworthiness, may not be appropriate. Those constituents supported the use of one readily available rate (for instance, a risk-free rate that approximates the lease term) to enhance comparability.
- A8. Short-term rentals, leases of most real estate, and leases embedded in contracts that are mostly for services are examples of leases in which some respondents think that it may be appropriate to use a risk-free rate to discount lease payments because that would result in more consistent and comparable information.
- A9. For those leases, a rate reflecting how an entity would have to borrow to buy the asset (the incremental borrowing rate) is not reflective of the lessee's intent. This is because the lessee does not view the leasing transaction as an alternative to purchasing the underlying asset:

In our opinion, the incremental borrowing rate could be considered an appropriate discount rate for measurement of finance leases currently being account for under IAS 17. This is because the lessee is interested in substantially all the benefits that can be obtained from the leased asset. However, we did not see the applicability of such rate when it comes to discounting arrangements currently classified as operating leases. The lessee would not be interest in purchasing the asset and the rate of interest

payable to finance such transaction could be considerably higher than the rate the lessor charges the lessee. (CL #423)

- A10. Another supporting reason to allow the use of a risk-free rate is that it would present a viable option for private companies and not-for-profit entities that do not have comparable debt to reference to. Allowing them to use a risk-free rate would reduce the cost burden of applying the prospective leases guidance.

We believe that some smaller private companies do not normally use long term debt as a source of financing. Some companies are owner financed and use leases as their only source of outside financing. The discount rate for these companies may not be as apparent as it would be to a company with a bank revolving line of credit. For this reason, we request that some form of safe harbor rate method be allowed as a proxy for the incremental borrowing rate used in lease discounting. (CL #488)

- A11. However, the staff thinks that if private companies are allowed to use a risk-free rate, then all lessees should be given that option for purposes of comparability. Otherwise, private companies would record higher lease obligations and reflect a lower cost of funds than public companies.
- A12. The staff however notes that the discount rate definition applied in the ED is an asset-specific rate and would be inconsistent with the use of a risk-free rate. Therefore, the staff thinks that using a risk-free rate would understate a lessee's leverage because it would result in a lower lease obligation.
- A13. Although a risk-free rate would generally enhance comparability, the staff understands that the majority of users think that an asset specific rate provides more useful information for evaluating the leverage resulting from lease contracts. Therefore, the staff suggests that a possible solution to users' requests that a comparable rate be used is through enhanced disclosure. That is, if the boards require the disclosure of the weighted-average discount rate used by the lessee to discount its leases, the users will have the information necessary to readjust the capitalization of leases to achieve the level of comparability that they are seeking (that is, they can adjust to risk-free rates, a "normalized" industry rate, or any rate they believe is more properly reflective of risk).
- A14. However, the staff thinks that the Board's should give further consideration to some of the arguments supporting use of a risk-free rate if they determine that

two types of leases exist. This is because the staff thinks that these arguments are more powerful when assessing lease contracts which do not have a significant financing element.

Concerns with using the incremental borrowing rate when there are options to extend or terminate a lease

A15. Constituents were concerned with the practical challenge of establishing a discount rate for leases when a contract includes options to extend or terminate the lease. For instance, if a lease has an initial term of 5 years with a 5 year-option to extend, should the incremental borrowing rate reflect:

(e) A debt for 5 years?

(f) A debt for 10 years?

(g) A debt for 5 years with an extension option for an additional 5 years?

A16. While the staff acknowledges that the theoretically correct answer would be to determine the incremental borrowing rate assuming debt for 5 years with an option to extend the debt for an additional 5 years, the staff also recognizes that the process is cumbersome, especially if an entity has no existing debt with comparable terms.

A17. The staff notes that at the February 16, 2011, joint board meeting, the boards tentatively decided on the following definition of lease term:

The lease term is the noncancellable period for which the lessee has contracted with the lessor to lease the underlying asset, together with any options to extend or terminate the lease when there is a significant economic incentive for an entity to exercise an option to extend the lease, or for an entity not to exercise an option to terminate the lease.

A18. Given the boards' tentative decisions on the accounting for options to extend or terminate a lease, the staff thinks that constituents' concerns should be at least partially alleviated because the lease obligation is economically more comparable to a borrowing with similar terms than it was under the previous definition of lease term in the ED.

- A19. The staff does not recommend that any additional guidance should be provided for determining the discount rate to be applied when a contract includes options to extend or terminate the lease.

Use of a group rate when financing normally occurs above the level of the lessee entity

- A20. Some lessees conduct all of their financing at a consolidated group/corporate level and identified concerns:

- (a) in which the interest rate incurred at the consolidated group/corporate level may not be the same as a subsidiary lessee's incremental borrowing rate; and
- (b) about their ability to determine an appropriate incremental borrowing rate in situations in which subsidiaries that, do not have other sources of financing other than their parent company, enter into a lease.

- A21. Some constituents argue that the use of a "group" or a "parent company" incremental borrowing rate may be appropriate in situations identified above, noting that it would be costly to require a subsidiary to determine an incremental borrowing rate. The staff thinks that the boards should provide application guidance in the final standard to address this matter.

Determining the yield on a property

- A22. The ED allows for the rate that the lessor charges the lessee to be the yield on the underlying property in the case of real estate leases. Under the IASB version of the ED, that would only pertain to investment property lessors that measure their investment properties at cost.

- A23. Some constituents disagreed with the use of the property yield as the discount rate:

An investment property is' a long term asset. Such a return requires estimates for periods as long as 30-50 years, with longer periods not uncommon. Such calculations are very subjective and depend on estimates of future rental rates, occupancy, expenses, financing amounts and rates, and eventual sales prices. As entities will use different assumptions, there will be significant divergence in practice. Because investment property contracts are not financings and do not have a traditional profit margins, the Association has

further questions whether an internal rate of return is the appropriate discount rate. (CL #594)

- A24. Other constituents suggested that additional guidance on determining the yield on a property might be helpful or necessary. They noted that the property yield could be calculated in a variety of ways, including:
- (a) Annual rent divided by the cost of the property; or
 - (b) Imputing the yield using the leases in place and unguaranteed residual value.
- A25. The staff thinks that the boards do not need to prescribe a specific method for determining the yield on the property. However, the staff thinks that a final standard should include application guidance on acceptable methods of how the yield on the property might be calculated.

Appendix B: preliminary draft wording relating to determination of the discount rate in a lease

The preliminary draft wording included in this appendix has been prepared by the staff to help the boards reach decisions on the determination of the discount rate in a lease. The preliminary draft wording takes the wording from paragraphs 12, 33, and 49 of the ED and the corresponding application guidance from Appendix B of the ED and 'marks-up' changes to that wording to reflect the approaches described in this paper

12. At the date of inception of the lease, a lessee shall measure:

(a) the liability to make lease payments at the present value of the lease payments (see paragraphs xx–xx), discounted using the lessee's incremental borrowing rate or, if it can be readily determined, the rate the lessor charges the lessee. If both rates are available the lessee should use the rate the lessor charges the lessee (see paragraph B11).

33/49. At the date of inception of the lease, a lessor shall measure:

(a) the right to receive lease payments at the sum of the present value of the lease payments (see paragraphs xx–xx), discounted using the rate the lessor charges the lessee (see paragraph B12), and any initial direct costs incurred by the lessor (see paragraphs B14 and B15).

Appendix B – Application Guidance Discount rate (paragraphs 12(a), 33(a) and 49(a))

B11. The discount rate used to determine the present value of lease payments for lessees is the lessee's incremental borrowing rate or the rate the lessor charges the lessee if that rate can be reliably determined. The lessee's incremental borrowing rate may be the same as the rate the lessor charges the lessee. If both rates are available, the lessee should use the rate the lessor charges in the lease.

B12. The discount rate used to determine the present value of lease payments for lessors is the rate that the lessor charges the lessee. The rate the lessor charges the lessee could be, for example, the lessee's incremental borrowing rate, the rate implicit in the lease (that is, the rate that causes the sum of the present value of cash flows and the present value of the residual value of the underlying asset at the end of the lease to equal the fair value of the underlying asset) or, for property leases, the yield on the property. When more than one indicator of the rate the lessor charges in the lease is available the rate implicit in the lease should be used.

B13. Both the lessee's incremental borrowing rate and the rate the lessor charges the lessee would reflect the nature of the transaction and the specific terms of the lease, such as lease payments, lease term, expected contingent rentals, expected payments under term option penalties and residual value guarantees, the expected value of the underlying asset at the end of the lease term and security attached to the underlying asset during and at the end of the lease term.

Additional application guidance will be drafted to address the other matters identified in Appendix A – Other matters relating to discount rates.