Project **Leases**

Topic **Reassessment of the Discount Rate in a Lease**

Objective

1. The purpose of this memorandum is to analyze whether there are circumstances that would require a lessee or a lessor to reassess the discount rate used to measure the present value of lease payments.

2. This paper is structured as follows:

   (a) Summary of staff recommendations

   (b) Summary of the proposals in the leases Exposure Draft (ED) and relevant decisions reached in redeliberations

   (c) Summary of feedback including comment letters and other outreach

   (d) Staff analysis

   (e) Appendix A – preliminary draft wording relating to the reassessment of the discount rate

   (f) Appendix B – illustration of approaches (separate document)

Summary of staff recommendations

3. The staff recommends the following:

   (a) The discount rate not be reassessed on a periodic basis when there is no change in lease payments

(b) The discount rate be reassessed in cases where there is a change in lease payments due to a change in the assessment of whether the lessee has a significant economic incentive to exercise an option to extend a lease or to purchase the underlying asset.

(c) The discount rate be reassessed in cases where there is a change in lease payments due to the exercise of an option that the lessee did not have a significant economic incentive to exercise.

(d) Determine a revised discount rate using the spot rate at the reassessment date and apply that rate to the remaining lease payments.

Summary of the proposals in the leases Exposure Draft (ED) and relevant decisions reached in redeliberations

Initial measurement and recognition

4. At the March 2011 Board meeting, the Boards discussed the accounting for a lease contract at the date of inception versus the date of commencement from both the lessee's and lessor's perspective. The Boards tentatively decided that the leases standard would require a lessee and a lessor to recognize and initially measure lease assets and lease liabilities (and derecognize any corresponding assets and liabilities) at the date of commencement of the lease, using a discount rate calculated at the date of commencement.

Reassessment of the discount rate

5. The ED proposes that neither the lessee nor the lessor shall change the rate used to discount the lease payments except to reflect changes in reference interest rates when contingent rentals are based on those reference interest rates. When contingent rentals are based on reference interest rates, a lessor shall recognize any changes to the right to receive lease payments arising from changes in the discount rate in profit or loss.

6. The impact on the discount rate resulting from changes in reference interest rates when contingent rentals are based on those reference interest rates is discussed in a separate memorandum.

Summary of feedback including comment letters and other outreach

7. Constituents generally agreed that the discount rate should not be reassessed, which would be consistent with amortized cost accounting for certain financial instruments and revenue recognition guidance. Most constituents were also concerned about the added cost and complexity of requiring discount rates to be reassessed.

8. However, other constituents questioned why the discount rate should not be reassessed. Those constituents noted inconsistencies with requirements in other accounting standards which require the adjustment of discount rates such as the accounting for pensions, insurance, and decommissioning liabilities/asset retirement obligations).

9. Those constituents pointed out that not changing the discount rate may result in the inability of an entity to properly reflect changes in the economics of a transaction. For instance, a constituent noted the following:

> It is also suggested that the discount rate should not generally be changed. This may give rise to unintended results. For example, suppose that a lease is priced reflecting some significant tax benefits such that the interest rate implicit in the lease is, say, 4% per annum, compared to a rate of 6% per annum for a lease with no tax benefits, and the lessor uses this rate as its discount rate. Suppose that the lease rentals vary with changes in tax assumptions and suppose also that, after the lease has commenced, there is a change in the tax legislation or interpretation thereof that eliminates or significantly reduces the tax benefits available to the lessor. The lessor therefore increases the rentals to reflect this change such that the revised interest rate implicit in the lease becomes 6% per annum. In such circumstances, it would not be appropriate to continue to discount the rentals at a tax adjusted discount rate of 4% per annum. (CL #122)

10. Another constituent pointed out that a reassessment of the discount rate would be necessary when certain types of options to extend the lease are exercised, such as fixed price or fair market value options where the lessee has no significant economic incentive to exercise, either at lease inception or thereafter. These options to extend would not have been included in the lease payments at the commencement of the lease and they economically represent new leases and should therefore reflect the discount rate at the time the option

to extend was negotiated, rather than the rate at the time of lease commencement:

> Additionally, since the Proposal does not allow revision of the discount rate, Company A would be required to use the same discount rate for 20 years in measuring the lease obligation which could potentially be not representative of the underlying economics. We believe fair market value renewal option or renewal option with substantial terms undefined is akin to a new lease and therefore such renewal option should not be included in assessing the "more likely than not" lease term at the inception of the contract. If such option is exercised, we believe the renewal period should be treated as a brand new lease and a new discount rate at the date of renewal should be used in measuring the lease obligation. (CL #542)

User feedback

11. Users generally supported reassessment of the discount rate. They stated that reassessment is important to ensure that financial information reflects management's most recent evaluation of economic circumstances and their affect on committed cash flows. For that reason, the following user specifically supported the reassessment of the discount rate when lease payments change:

> We do not agree with the remeasurement principle which allows changes in expected lease payments or the right to receive lease payments be discounted at the rate in effect at the inception of the lease rather than the current interest rates. (CL #780)

Private company feedback

12. Feedback from private companies was consistent with that from all other entities. They also think that reassessment of the discount rate would be costly and burdensome.

Staff analysis

13. Under the provisions in the ED, neither the lessee nor the lessor would be permitted to change the discount rate after inception unless lease payments are contingent on variable reference interest rates. This is to be consistent with the notion of cost-based measurement and is less complex and costly for preparers to apply.

Reassessment of discount rates in other guidance

14. Requiring reassessment of the discount rate would result in inconsistency with other guidance:

    (a) The measurement principles of amortized cost in IFRS 9 *Financial Instruments* and Topic 310 *Receivables* do not require reassessment of the discount rate. Some view financial assets and liabilities as economically comparable to the lessor's receivable and the lessee's obligation, respectively.

    (b) When a sale contract requires payments to be made over a sufficiently long period of time so as to require the discounting of those payments, neither current nor proposed revenue recognition guidance requires reassessment of the discount rate.

15. Reassessment of the discount rate is required for asset retirement obligations (or decommissioning liabilities under IFRSs). Topic 410 requires that, when upward revisions to a asset retirement obligation, a current discount rate would be applied to that increase in the amount:

    > 410-20-35-8 Changes resulting from revisions to the timing or the amount of the original estimate of undiscounted cash flows shall be recognized as an increase or a decrease in the carrying amount of the liability for an asset retirement obligation and the related asset retirement cost capitalized as part of the carrying amount of the related long-lived asset. Upward revisions in the amount of undiscounted estimated cash flows shall be discounted using the current credit-adjusted risk-free rate. Downward revisions in the amount of undiscounted estimated cash flows shall be discounted using the credit-adjusted risk-free rate that existed when the original liability was recognized.

16. Similarly, accounting for pension liabilities requires the use of a revised discount rate every period, because the amount of the pension obligation changes every period.

17. In examining current accounting guidance and prospective guidance in other ongoing projects, the staff noted that the key difference in comparing pension liabilities and asset retirement obligations to amortized cost-basis financial instruments is that, in the former, changes to the discount rate are necessary because the total amount of consideration subject to the discount is changing every period. In the latter, the total amount to be collected (on an asset) or to

be paid (on a liability) is relatively fixed, except for the impact of any payments reliant on a reference index rate.

Reassessment of the discount rate when there is no change in lease payments

18. The staff agree that it would be unduly burdensome to require the reassessment of discount rates every period, when there is no change in estimated lease payments. This would be consistent with amortized cost-basis financial instruments and revenue recognition accounting, where there is no change in the total consideration paid under the terms of the contract (ignoring index-based changes to interest rates).

Question 1
Do the Boards agree with the staff recommendation that the discount rate not be reassessed on a periodic basis when there is no change in lease payments?

Reassessment of the discount rate when there is a change in lease payments

19. The staff thinks it would be appropriate to require the reassessment of the discount rate when the amount of lease payments change due to the following:
    (a) A change in the evaluation of whether a lessee has a significant economic incentive to exercise an option to extend a lease or to purchase the underlying asset.
    (b) The actual exercise of an option to extend or a purchase option where the lessee did not have a significant economic incentive to exercise the option.

A change in lease payments due to reassessment of economic incentive

20. In the case of a lease with an option to extend, updating the discount rate when there is an increase in lease payments may be more appropriate to reflect the lessee's lease obligation at a rate that is closer to the lessee's cost of funds at the date of the reassessment rather than the lessee's cost of funds at the date of lease commencement. Updating the discount rate for the remaining obligation

would be consistent with accounting for asset retirement obligations / decommissioning liabilities and pension obligations.

21. However, the staff also noted several challenges to reassessing the discount rate when there is a change in lease payments:

    (a) In some cases, the rate charged by the lessor may already take into account the fact that the lease arrangement includes an option to extend the lease (that is, the rate may already incorporate the probability that an option to extend will be exercised, for example, because it will be in-the-money at the exercise date). In such cases, the requirement to update the discount rate would be unnecessary.

    (b) It would be difficult and costly to adjust the discount rate for a lease with multiple reassessments during its initial lease term, especially for a lessor applying the derecognition approach to lessor accounting.

A change in lease payments due to exercise of an option to extend that the lessee had no significant economic incentive to exercise

22. The staff thinks that there is an argument that when a lessee actually exercises an option to extend that it had no economic incentive to exercise, that should reflect a revised discount rate. Updating the discount rate for the remaining obligation would be consistent with accounting for asset retirement obligations/ decommissioning liabilities and pension obligations.

23. For an actual exercise of an option, there is no issue of the added complexity of multiple reassessments, because the actual exercise of an option cannot be reversed. Further, for options where the lessee had no economic incentive to exercise, reassessment of the discount rate would appropriately recognize that such exercise is economically similar to entering into a new lease – for the lessee, the extension of the lease economically represents a new obligation. Note, however, the staff does not consider this to be a new lease for accounting purposes, as recommended in a separate memo.

Determining what discount rate to use and to which lease payments to apply that rate

24. The staff note that the Boards have required that a lease be initially measured at the present value of lease payments, using a discount rate determined at

lease commencement. If the lessee and lessor are required to update the discount rate, two approaches are being presented for the Boards' consideration:

(a) Approach 1: Determine a revised discount rate using the spot rate at the reassessment date and apply that rate to the remaining lease payments, including the remaining payments on the initial lease plus the payments due during the extension period or upon the exercise of a purchase option. For instance, consider if a lessee uses its incremental borrowing rate as the discount rate, and determines that rate based on what it would be charged on a borrowing with a repayment schedule that includes both the initial lease term plus the extension term. That rate should consider the market rate that would be charged at the date of reassessment, in consideration of the lessee's credit and the underlying asset's value as of that date. See Example 1 in Appendix B.

(b) Approach 2: Estimate what the discount rate would be at the beginning of the extension period (estimate using a forward rate) and apply that rate to only the payments due during the extension period. See Example 2 in Appendix B.

25. The staff thinks that Approach 1 would be consistent with the Boards' decision for how the discount rate would be determined on the date of commencement of the lease. That is, the date of reassessment would effectively be the commencement date of the "revised" lease.

26. Approach 2 would require applying the original discount rate to the original lease payments and applying a new forward rate to the lease payments in the extension period. This approach would effectively consider the arrangement to be two separate leases. This approach also would be inconsistent with how the discount rate is determined for the original lease since a forward rate determined at a time period before commencement of the "second" lease would be used to discount the lease payments.

27. Approach 2 also would be more complex than Approach 1 because it would require:

(a) The lessee to accrue interest on its lease obligation at two different rates, one each for the payments related to the current lease term and for the payments related to the extended lease term,

(b) The lessee to track two separate right-of-use assets, one each related to the current lease term and to the extended lease term.

Staff recommendations

28. The staff recommends that:

(a) The discount rate be reassessed in cases where there is a change in lease payments due to a change in the assessment of whether the lessee has a significant economic incentive to exercise an option to extend a lease or to purchase the underlying asset. The staff think that requiring reassessment of the discount rate in these cases is warranted because it would be consistent with similar accounting guidance for asset retirement obligations/decommissioning liabilities and pension obligations. The staff thinks, however, that application guidance should be included in the final standard to clarify that the discount rate does not need to be reassessed if the determination of that discount rate at lease commencement included a consideration of the optionality in the lease contract.

(b) The discount rate be reassessed in cases where there is a change in lease payments due to the exercise of an option that the lessee did not have a significant economic incentive to exercise.

(c) A lessee/lessor should apply Approach 1 for determining and applying a discount rate at the date of reassessment. See Example 1 in Appendix B.

29. The draft wording in Appendix A reflects the staff recommendations.

Question 2
The staff recommends that the discount rate be reassessed in cases where there is a change in lease payments due to a change in the assessment of whether the lessee has a significant economic incentive to exercise an option to extend a lease or to purchase the underlying asset.

Do the Boards agree?

Question 3

The staff recommends that the discount rate be reassessed in cases where there is a change in lease payments due to the exercise of an option that the lessee did not have a significant economic incentive to exercise.

Do the Boards agree?

Question 4

The staff recommend Approach 1 for determining and applying the discount rate upon reassessment.

Do the Boards agree?

Appendix A: preliminary draft wording relating to the reassessment of options to extend or terminate a lease or purchase the underlying leased asset

The preliminary draft wording included in this appendix has been prepared by the staff to help the Boards reach decisions regarding the scope of the leases standard. The Boards have not yet made decisions about the views reflected in this appendix, and, therefore, the wording is subject to change. This appendix shows marked changes from what was originally proposed in the Exposure Draft on leases. Note that the italicized portions in the paragraphs below represent that language in the Exposure Draft that is addressed by another staff paper.

19/40/57. A lessee/lessor shall not change the rate used to discount the lease payments except in the following circumstances:

a) when there is a change in lease payments resulting from either:

   i. the a reassessment of whether the lessee has a significant economic incentive to exercise of an option to extend a lease or purchase the underlying asset

   ii. the exercise of an option that the lessee did not have a significant economic incentive to exercise.

A lessee/lessor shall determine a discount rate calculated at the date of the reassessment and apply that rate to all remaining lease payments.

b) *to reflect changes in reference interest rates when contingent rentals are based on those reference interest rates. When contingent rentals are based on reference interest rates, a lessee shall recognise any changes to the liability to make lease payments arising from changes in the discount rate in profit or loss.*

Application Guidance:

A lessee/lessor is required to change the rate used to discount lease payments when there is a change in lease payments resulting from a reassessment of lease payments or an exercise of an option to extend a lease. However, a lessee/lessor does not have to change the discount rate if the lessee/lessor considered the optionality in the lease contract in determining the discount rate used at initial measurement.