IASB Agenda ref	3D
FASB Agenda ref	280

STAFF PAPER

April 2014

FASB | IASB Meeting

Project	Leases		
Paper topic	Discount Rate		
CONTACT(S)	Stephen Winick	smwinick@fasb.org	+1 203 956 3443
	Scott A. Muir	samuir@fasb.org	+1 203 956 3478
	Patrina Buchanan	pbuchanan@ifrs.org	+44 (0)20 7246 6468

This paper has been prepared by the staff of the IFRS Foundation and the FASB for discussion at a public meeting of the FASB or IASB. It does not purport to represent the views of any individual members of either board. Comments on the application of US GAAP or IFRSs do not purport to set out acceptable or unacceptable application of U.S. GAAP or IFRSs. The FASB and the IASB report their decisions made at public meetings in FASB Action Alert or in IASB Update.

Introduction

1. The purpose of this paper is to provide the Boards with information and analysis of the following three topics associated with the discount rate used to measure, at present value, the lessee's lease liability and the lessor's lease receivable and residual asset (for lessor Type A leases):
   (a) Determination of the Discount Rate
   (b) Reassessment of the Discount Rate
   (c) FASB Only: Risk-Free Rate Accounting Policy Election for Nonpublic Entities.
2. This paper is structured as follows:
   (a) Summary of Staff Recommendations
   (b) Determination of the Discount Rate:
      (i) Background
      (ii) Summary of Proposals in the 2013 ED
      (iii) Summary of Feedback Received on the 2013 ED

The IASB is the independent standard-setting body of the IFRS Foundation, a not-for-profit corporation promoting the adoption of IFRSs. For more information visit www.ifrs.org

The Financial Accounting Standards Board (FASB), is the national standard-setter of the United States, responsible for establishing standards of financial accounting that govern the preparation of financial reports by nongovernmental entities. For more information visit www.fasb.org

(iv) Relevant Decisions Reached in Redeliberations

(v) Staff Analysis

(vi) Staff Recommendation.

(c) Reassessment of the Discount Rate:

(i) Background

(ii) Summary of Proposals in the 2013 ED

(iii) Summary of Feedback Received on the 2013 ED

(iv) Reassessment of the Discount Rate in Other Guidance

(v) Relevant Decisions Reached in Redeliberations

(vi) Staff Analysis

(vii) Staff Recommendation.

(d) FASB Only*:* Risk-Free Rate Accounting Policy Election for Nonpublic Entities:

(i) Summary of Proposals in the 2013 ED

(ii) Summary of Feedback Received on the 2013 ED

(iii) Staff Analysis and Recommendation.

(e) Appendix A – Illustrative Examples.

Summary of Staff Recommendations

3. With respect to determination of the discount rate, the staff recommend the following:

(a) Describe the rate the lessor charges the lessee as the rate implicit in the lease, consistent with existing lessor guidance;

(b) Include initial direct costs of the lessor in the definition of the *rate implicit in the lease*;

(c) Clarify in the implementation guidance what *value* refers to in the definition of the *lessee's incremental borrowing rate*, but otherwise make no changes to the definition;

(d) Include at least one example illustrating how to determine the lessee's incremental borrowing rate in the implementation guidance; and

(e) Provide guidance as to when a subsidiary might use the parent entity or group's incremental borrowing rate as the discount rate applied to its leases.

4. With respect to reassessment of the discount rate, the staff recommend the following:

(a) Not require reassessment of the discount rate for lessors

(b) Require lessees to reassess the discount rate *only* when there is a change to either:

(i) The lease term; or

(ii) The assessment of whether the lessee is, or is not, reasonably certain to exercise an option to purchase the underlying asset.

5. The staff recommend that the FASB retain the risk-free rate accounting policy election for nonpublic entities.

Determination of the Discount Rate

Background

6. Existing capital lease guidance in Topic 840 requires that a lessee shall compute the present value of the minimum lease payments using the lessee's **incremental**

borrowing rate[1] unless both of the following conditions are met, in which circumstance the lessee shall use the **implicit rate**:

(a) It is practicable for the lessee to learn the implicit rate computed by the lessor.

(b) The implicit rate computed by the lessor is less than the lessee's incremental borrowing rate.

7. Existing finance lease guidance in IAS 17 is similar in that it requires a lessee to measure finance lease liabilities using the interest rate implicit in the lease (if this is practicable to determine), or otherwise its incremental borrowing rate.[2]

8. IAS 17 defines the interest rate implicit in the lease as the discount rate that causes the aggregate present value of (a) 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.

9. The rate implicit in the lease is defined similarly in Topic 840, except that: (a) the initial direct costs of the lessor would *not* be taken into account when determining the interest rate implicit in the lease under either Topic 840 or the 2013 ED, while (b) any investment tax credit retained and expected to be realized by the lessor is taken into account under Topic 840.

Summary of Proposals in the 2013 ED

Lessee

10. The 2013 ED proposed that the lessee should discount its lease liability at the rate the lessor charges the lessee when that rate is readily determinable; otherwise, the lessee should use its incremental borrowing rate.

[1] The *incremental borrowing rate* is currently defined in Topic 840 as "the rate that, at lease inception, the lessee would have incurred to borrow over a similar term the funds necessary to purchase the leased asset."
[2] The *lessee's incremental borrowing rate of interest* is currently defined in IAS 17 as "the rate of interest the lessee would have to pay on a similar lease or, if that is not determinable, the rate that, at the inception of the lease, the lessee would incur to borrow over a similar term, and with a similar security, the funds necessary to purchase the asset."

11. The rate the lessor charges the lessee should take into account the nature of the transaction as well as the terms and conditions of the lease, and could be, for example, the rate implicit in the lease or the property yield.

Lessor

12. The 2013 ED proposed that the lessor should discount its lease receivable and residual asset using the rate it charges the lessee.

Summary of Feedback Received on the 2013 ED

13. Most constituents did not comment on the discount rate proposals in the 2013 ED, and very few commented on the proposals with respect to determining the lessor's discount rate. There was broad support among those constituents that provided feedback on this topic for the lessee to use its incremental borrowing rate in the absence of information about the rate the lessor charges the lessee.

14. Those respondents that commented on the lessor's discount rate generally had concerns about the definition of the *rate implicit in the lease*. A few respondents to the 2013 ED indicated that it would be more appropriate to define the rate implicit in the lease consistently with the definition in IAS 17—that is, the rate implicit in the lease should be determined taking into account the initial direct costs of the lessor *as well as* the fair value of the underlying asset. Those respondents provided the following arguments in support of this view:

    (a) *The IAS 17 definition would more closely align the definition of the implicit rate with the rate actually charged by the lessor.* A lessor pricing a lease would typically be expected to price the lease to ensure that it obtains an appropriate return on the lease, including the recovery of any initial direct costs associated with entering into the lease. Because of this, *not* including the lessor's initial direct costs when determining the implicit rate would result in a rate that is higher than the rate actually charged in the lease and higher than the lessee's incremental borrowing rate.

(b) *The IAS 17 definition would result in less complex lessor accounting*. Assuming that the Boards confirm that a finance lessor is required to capitalize initial direct costs, defining the implicit rate as it is defined in IAS 17 would result in less complex accounting. Example 1 to the 2013 ED (ASC paragraphs 842-30-55-7 though 20) / Illustrative Example 19 in the IFRS version of the 2013 ED illustrated that, the requirement to capitalize initial direct costs combined with the definition of the implicit rate in the 2013 ED, would result in the lessor applying a discount rate to the lease receivable from day 2 of the lease that would differ from the implicit rate applied to the lease receivable at lease commencement. Amending the definition of the implicit rate to include initial direct costs would solve this complexity because the lessor would apply the implicit rate to the lease receivable both at lease commencement and throughout the lease term.

(c) *The 2013 ED definition could result in anomalous results*. In some more extreme scenarios, the definition of the implicit rate in the 2013 ED could result in a lessor accounting for a lease as if it were priced to include a negative return on a lease, when the lease was actually priced to earn a small but positive return.

15. Concerns among constituents that provided feedback on the lessee discount rate proposals included the following:

(a) Requests for more guidance on certain aspects, including what is "readily determinable."

(b) Some expressed concern about the definition of the lessee's incremental borrowing rate as it is defined in the 2013 ED:

> 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.

These constituents note that right-of-use (ROU) assets do not exist outside of leases. Consequently, it would be difficult to determine an incremental borrowing rate in accordance with this definition.

(c) Several said that calculating incremental borrowing rates for individual leases would impose a significant administrative burden on their organizations and increase their system requirements.

(d) Some are concerned about the comparability of lease liabilities within and between entities. For example, an entity that operates in multiple jurisdictions is likely to have a different incremental borrowing rate in each jurisdiction. Therefore, an entity could recognize two leases with identical payments and lengths at different amounts.

(e) Some U.S. constituents note that industry regulations require them to comply with the Cost Accounting Standards (CAS) and the Federal Acquisition Regulation (FAR). These constituents enter into leases exclusively to support various government contracts and are reimbursed using a predetermined rate referred to as the "cost of money". They would prefer to use that rate to discount their liabilities.

Relevant Decisions Reached in Redeliberations

16. At the March 2014 joint Board Meeting, the Boards decided to permit lessees and lessors to apply the leases guidance at a portfolio level. The FASB decided to include the portfolio guidance in the basis for conclusions; the IASB decided to include the portfolio guidance in the application guidance. The March 2014 Agenda Paper 3F/FASB Memo 273 described the staff's view that a portfolio approach could simplify the determination of key judgments and estimates, including the determination of the discount rate. Therefore, the staff do not think that the Boards need to reaffirm that lessees and lessors could use a portfolio approach to determine the appropriate discount rate for leases. The staff think that use of a portfolio approach to determine the discount rate for leases would

substantially address the concerns of those constituents that commented that calculating incremental borrowing rates for individual leases would impose a significant administrative burden on their organizations. Example 4 in Appendix A of this paper demonstrates *one* way in which the staff think a portfolio approach could be applied with respect to determining the discount rate for leases.

Staff Analysis

Lessor—Discount Rate

17. The staff think that there are two changes to the 2013 ED proposals regarding the rate the lessor charges the lessee that the Boards could consider, in light of their decision in March 2014 that the results of existing lessor accounting would not be fundamentally changed in the final leases standard.

18. The first change relates to the description of "the rate the lessor charges the lessee". The 2013 ED stated that "the rate the lessor charges the lessee could be, for example, the rate implicit in the lease or the property yield." The 2013 ED also stated that "An entity shall use the rate implicit in the lease as the rate the lessor charges the lessee whenever that rate is available."

19. Because of the Boards' decision regarding the lessor accounting model at the March 2014 meeting, the staff think that the rate the lessor charges the lessee should be defined as the rate implicit in the lease, similarly to existing lessor accounting guidance in IFRS and U.S. GAAP, for two reasons:

    (a) *There is no longer a need to widen the description of the rate the lessor charges the lessee beyond the rate implicit in the lease*. The 2010 ED and the 2013 ED proposed that a lessor would recognize a lease receivable for a much larger population of leases than is the case under existing lessor requirements. This would have required lessors to calculate an appropriate discount rate for that larger population of leases. Because of this, there was a need to widen the description of the rate the lessor charges the lessee so that it could be applied by lessors

that do not directly include an implicit interest rate when pricing leases. For example, lessors of many property leases and leases of, for example, rail cars or drilling rigs indicated that it would be difficult to determine the rate implicit in the lease because they do not price their leases to include such a rate—their pricing is very much dictated by the market price for leasing the underlying asset at lease commencement. Those lessors monitor the yield they generate on a leased asset over the life of the asset but generally would not include an implicit interest rate in each individual lease. The Boards' decisions in March 2014 mean that a lessor would recognize a lease receivable only for existing finance leases, which are typically priced to include an implicit interest rate. The staff are not aware of any issues in practice today regarding the determination of the rate implicit in a sales-type/direct-financing (U.S. GAAP) or finance (IFRS) lease.

(b) *The use of the property yield by a lessee has the potential to result in inconsistent measurement of lease assets and liabilities*. When measuring lease assets and liabilities, a lessee would use the rate the lessor charges the lessee if it is readily determinable. Property yields for properties in particular locations (for example, London and other parts of the UK) are publicly available. For this reason, a lessee with property leases may be able to decide to use the property yield, instead of its incremental borrowing rate, for at least some of its property leases. The staff understand that property yields, at present, would be expected to be significantly higher than many lessees' incremental borrowing rates, given the lower interest rate environment. For example, the staff understand that property yields in London are in the region of 7.5 percent - 8 percent at a time when many lessees' incremental borrowing rates are considerably lower. Inclusion of the property yield within the description of the rate the lessor charges the lessee could create the

potential for lessees to choose whether to recognize significantly larger or smaller lease liabilities by choosing whether to use the property yield or its incremental borrowing rate when discounting the lease payments for some leases.

20. The second change with respect to the rate the lessor charges the lessee relates to the definition of the *rate implicit in the lease*. The staff think that the Boards should revise the definition of the *rate implicit in the lease* to more closely align with the definition in IAS 17. The staff would recommend defining the *rate implicit in the lease* along the following lines:

> The rate of interest that, at a given date, causes the sum of the present value of (a) payments made by a lessee for the right to use an underlying asset and (b) the amount a lessor expects to derive from the underlying asset following the end of the lease term to equal the sum of (i) the fair value of the underlying asset and (ii) any capitalized initial direct costs of the lessor.

21. The staff recommendation with respect to revising the definition of the *rate implicit in the lease* is based principally on the view that revising this definition would simplify lessor accounting as compared to the proposals in the 2013 ED, and would result in outcomes that are generally consistent with existing lessor accounting. The staff think this recommendation would simplify lessor accounting as compared to the proposals in the 2013 ED because, rather than having to establish one discount rate for determining the initial lease receivable and another for determining interest income thereon, the *rate implicit in the lease* would be defined in such a way that the initial direct costs are automatically included in the Type A lease receivable. Therefore, a lessor would need to determine only a single discount rate and would not need to add initial direct costs to the lease receivable separately.

22. Consistent with existing lessor accounting guidance, a lessor would not capitalize initial direct costs if it *recognizes* selling profit on the underlying asset at lease commencement. Instead, a lessor would recognize as an expense initial direct costs associated with Type A leases for which the lessor recognizes selling profit at lease commencement. Other issues with respect to initial direct costs (for example, in the context of a lessor's Type B leases for which the lessor does not calculate a discount rate) will be discussed at a future meeting.

Lessee—Discount Rate

23. The staff think that the Boards could consider one or more of the following with respect to clarifying or simplifying the guidance on determining the discount rate for lessees:

    (a) Revising the definition of the *lessee's incremental borrowing rate* to address constituent feedback

    (b) Providing additional application guidance on determining the lessee's incremental borrowing rate

    (c) Clarifying when, if ever, a lessee that is a subsidiary of another entity can or should determine the appropriate discount rate from the parent entity's perspective (for example, based on the parent's or group's credit rating and/or the economic environment in which the parent operates).

24. With respect to the definition of the *lessee's incremental borrowing rate*, the staff think that the definition is broadly consistent with that in both Topic 840 and IAS 17. Most constituents did not express concerns about the proposed definition. However, for those that expressed concerns such as those outlined in the feedback summary above, the staff think that the Boards could consider clarifying that in determining the "funds necessary to obtain an asset of a similar value to the right-of-use asset", *value* refers to the cost of the ROU asset. The staff think that this

could be accomplished with as little as one added sentence to the implementation guidance where application of the discount rate is already discussed.

25. The staff do not think that use of another common discount rate term, such as "credit-adjusted risk-free rate," which is used in Topic 410 – *Asset Retirement Obligations* and Topic 420 – *Exit or Disposal Cost Obligations*, would simplify application of the discount rate guidance. This is because the accounting literature does not provide explicit guidance on how to establish this rate, and interpretive guidance from some accounting practitioners describe how to establish the credit-adjusted risk-free rate by reference to the "entity's incremental borrowing rate on debt of a similar maturity."

26. The staff think that the Boards could consider providing one or more examples of how to determine the lessee's incremental borrowing rate in the implementation guidance to the final leases standard. Examples 1-3 in Appendix A to this paper provide possible examples that the Boards could decide to include in the final leases standard.

27. The staff think that the Boards could consider allowing a subsidiary to use the parent entity or group's incremental borrowing rate as the discount rate for its leases in some situations. Depending on the terms and conditions of the lease and the corresponding negotiations, the parent entity's incremental borrowing rate may be the most appropriate rate to use as a practical means of reflecting the interest rate in the contract. For example, assume that an Argentinian subsidiary of a large European group enters into a lease for a large piece of equipment. The subsidiary does not have its own treasury function—all funding for the group is managed centrally by the parent entity. The negotiations with the lessor result in the parent entity providing a guarantee of the lease payments to the lessor and the pricing of the lease is, consequently, influenced by the credit standing of the parent, rather than the subsidiary. In that case, and assuming that the rate implicit in the lease is not readily determinable by the lessee, the most appropriate incremental borrowing rate to use to best reflect the rate in the contract is likely to

be the parent entity's incremental borrowing rate. In contrast, the staff think that it would generally be inappropriate for a subsidiary lessee to use its parent entity's incremental borrowing rate when the subsidiary conducts its own treasury operations (for example, issues its own debt or has its own credit facility). This is because the pricing of such a subsidiary's lease contract would be expected to be largely determined on the basis of the credit profile of the subsidiary leasing the underlying asset.

28. The staff think that the objective when determining the appropriate discount rate to use when measuring lease assets and liabilities is to find the rate that best reflects the interest rate embedded within the contract—that is, the rate the lessor charges the lessee. Accordingly, if readily determinable, a lessee would use the rate implicit in the lease. Nonetheless, the staff would expect that the rate implicit in the lease would *not* be readily determinable by most lessees. Accordingly, the lessee's incremental borrowing rate is used as a proxy or practical means of trying to reflect the rate the lessor charges the lessee.

29. The staff think that it might be helpful to include some guidance (potentially, by example) that indicates that a parent entity or group's incremental borrowing rate may be an appropriate rate to use for some leases in terms of meeting the objective of reflecting the interest rate in the contract. That guidance also could indicate when it might not be the case. The staff think that such a clarification may help to reduce costs for some entities in two ways. A subsidiary that does not have its own treasury function or any form of debt may not need to determine its incremental borrowing rate. In addition, the parent entity may find the guidance helpful when establishing a portfolio-based discount rate. For example, the parent may be able to establish *one* discount rate for all leases with similar terms and conditions entered into by the group during a particular timeframe, rather than each subsidiary calculating a different discount rate for substantially similar leases.

30. Lastly, regarding the final item of feedback with respect to the lessee's discount rate outlined above, the staff do not recommend providing some U.S. constituents that are required to comply with the Cost Accounting Standards (CAS) and the Federal Acquisition Regulation (FAR) with the ability to use the "cost of money" as their discount rate in the final leases standard. The staff think that the "cost of money" rate used to reimburse such constituents is not necessarily linked to the rate the lessor charges the lessee in the lease, nor is it necessarily linked to the lessee's incremental borrowing rate. Consequently, the staff do not think that it is an appropriate proxy for the interest rate in the contract.

Staff Recommendation

31. In summary, with respect to determination of the discount rate, the staff recommend the following:

   (a) Describe the rate the lessor charges the lessee as the rate implicit in the lease, consistent with existing lessor guidance;

   (b) Include initial direct costs of the lessor in the definition of the *rate implicit in the lease*;

   (c) Clarify in the implementation guidance what *value* refers to in the definition of the *lessee's incremental borrowing rate*, but otherwise make no changes to the definition;

   (d) Include at least one example illustrating how to determine the lessee's incremental borrowing rate in the implementation guidance; and

   (e) Provide guidance as to when a subsidiary might use the parent entity or group's incremental borrowing rate as the discount rate applied to its leases.

Question 1: Determination of the Discount Rate
Question 1 – Do the Boards agree with the staff recommendations outlined above? If not, what would the Boards prefer instead?

Reassessment of the Discount Rate

Background

32. Existing U.S. GAAP (in Topic 840) and IFRS (in IAS 17) do not require reassessment of the discount rate for the lessee or the lessor.

Summary of Proposals in the 2013 ED

33. The 2013 ED proposed that a lessee would reassess the discount rate if there is a change in any of the following, unless the possibility of change was reflected in determining the discount rate at the commencement date:

    (a) The lease term

    (b) Relevant factors that result in the lessee having or no longer having a significant economic incentive to exercise an option to purchase the underlying asset

    (c) A reference interest rate, if variable lease payments are determined using that rate.

34. A lessee and a lessor would determine the revised discount rate at the date of reassessment as the rate the lessor would charge the lessee at that date (or, if that rate is not readily determinable for the lessee, the lessee's incremental borrowing rate at that date) on the basis of the remaining lease term.

35. In the 2013 ED the Boards decided that, in most cases, an entity should not reassess the discount rate during the lease term. That is generally consistent with amortized cost accounting. In other IFRSs or U.S. GAAP in which the discount

rate is required to be reassessed, it is usually because the liability to which the discount rate relates is measured on a current measurement basis.

36. In the Boards' view, as expressed in paragraph BC181 in the 2013 ED, there are certain circumstances in which an entity should reassess the discount rate, for example, when there is a change in the lease term or the assessment of whether the lessee has a significant economic incentive to exercise an option to purchase the underlying asset. In those circumstances, the economics of the lease have changed and those changes should be reflected in the discount rate. For example, if an entity previously accounted for a lease on the basis that it has a remaining term of 5 years, and that remaining lease term changes to 10 years, it is appropriate to reassess the discount rate to be consistent with the change in the lease payments included in the measurement of lease assets and liabilities. However, the Boards decided that such a change to the discount rate would be required only if an entity had not taken into account the optionality in the contract when determining the discount rate at the commencement date. It is not necessary to update the discount rate if that rate already reflects that an entity has an option to extend or terminate the lease or to purchase the underlying asset.

Summary of Feedback Received on the 2013 ED

37. Most constituents did not comment on the discount rate proposals in the 2013 ED. However, among those constituents that provided feedback on this topic, there was broad concern about continuous reassessment of the discount rate (that is, reassessment at every reporting period and as a result of certain events).

38. One large preparer commented:

> We believe that the costs of continuously reassessing each individual lease and simultaneously re-measuring the underlying assets and related liabilities, is significant when considering the overall impact this type of analysis will have on our financial statements. We understand the relevance to performing the reassessment;

> however we believe we would incur significant costs for implementing and maintaining such processes. Specifically, the tasks associated with identifying, inputting and continuously monitoring key elements of the underlying calculations require significant manual effort that cannot be automated by a system solution. As the impact of a continuous reassessment would likely not be material to our financial statements, we do not believe this process would provide useful information for our users and therefore the costs would outweigh the potential benefits. We suggest, as an alternative, the lease assessment process should be similar to the subsequent assessment and measurement requirements in ASC 350-30¬35-18 relating to intangible asset impairments. Specifically, leases should be reassessed annually, or more frequently if events or changes in circumstances indicate that the company's economic incentive related to the leases has changed. We believe events that trigger reassessment prior to the company's annual analysis should be only those that have significant impact on the company and its operations, such as discontinuing a product line, relocating operations, regulatory changes or other events having a significant impact on the use of the underlying leased assets. CL #322

39. These commenters generally were concerned with the cost of performing the reassessment analysis and offered the following suggestions as potential simplifications:
    - (a) Only require reassessment if there are significant triggering events.
    - (b) Only require reassessment when there have been significant changes impacting the total lease portfolio within a lessee or lessor business

rather than on a lease-by-lease basis (that is, allow a portfolio approach for reassessment).

40. A few constituents asked the Boards to clarify how a lessor would demonstrate whether the possibility of future changes in lease payments is reflected in the rate the lessor charges the lessee. Additionally, they asked the Boards to provide application guidance to illustrate the calculation of a discount rate that reflects the possibility of a future change in the lease payments.

41. Finally, a few constituents explicitly agreed with the Boards' reassessment proposals. For example, one preparer stated:

> With respect to reassessment of the discount rate, we agree with the Board's proposal to require reassessment when there are changes in the lease term, the expectation of an option exercise (subject to the concerns discussed above regarding reassessment of options), and a reference interest rate if variable lease payments are determined using that rate (subject to the concerns described above regarding reassessment of variable lease payments that depend on an index or rate). CL #291

Reassessment of the Discount Rate in Other Guidance

42. Reassessment of the discount rate is required in particular circumstances under both U.S. GAAP and IFRS. For example, in U.S. GAAP the discount rate used with respect to asset retirement obligations is updated when there are upward revisions to the estimate of undiscounted cash flows that will be required to settle the obligation. In IAS 37, the discount rate is updated as necessary to reflect current market assessments of the time value of money and the risks specific to the liability.

43. Similarly, U.S. GAAP accounting for pension liabilities requires the use of a revised discount rate at each period-end to reflect the rate at which the pension benefits could be effectively settled at the reporting date.

44. In examining existing accounting guidance and prospective guidance in other active projects, the staff noted that there is a key difference in comparing liabilities such as those related to pensions and asset retirement obligations in U.S. GAAP (and those subject to IAS 37 in IFRS) to amortized cost-basis financial instruments. In the former, changes to the discount rate are necessary because the total amount of consideration subject to the discount changes. 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 effect of any payments reliant on a reference index or interest rate. In the final leases standard, a lessee would measure lease liabilities on an amortized cost basis but, similar to pension and asset retirement (decommissioning) obligations, the total amount of consideration subject to the discount may change when reassessments occur.

45. However, 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. The lessor's receivable and the lessee's liability are financial assets and liabilities that can be viewed as economically comparable to other similar financial assets and liabilities.

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

Relevant Decisions Reached in Redeliberations

46. At the March 18-19, 2014 joint Board meeting, the Boards reached a number of decisions relevant to the reassessment of the discount rate.

    (a) First, the Boards decided that a lessee should reassess (a) the lease term and (b) whether the lessee is, or is not, reasonably certain of exercising an option to purchase the underlying asset, only upon the occurrence of a significant event or a significant change in circumstances that are within the control of the lessee.

    (b) Second, the Boards decided that lessors should not reassess (a) the lease term or (b) whether the lessee is, or is not, reasonably certain of exercising an option to purchase the underlying asset.

    (c) Lastly, the Boards decided to permit the leases guidance to be applied at a portfolio level by lessees and lessors. The March 2014 Agenda Paper 3G/FASB Memo 274 outlined the staff's view that the need to reassess the lease term and whether or not the lessee is reasonably certain to exercise a purchase option could be applied at a portfolio level. For example, assume a lessee has determined that it can account for 1,000 leased machines as a single lease portfolio based on the proposed portfolio guidance. In this case, making a modification or customization to one or only a relatively small number of those machines would generally not be considered a significant change in circumstances that would affect the assessment of whether the lessee is, or is not, reasonably certain to exercise an option. Conversely, a series of asset modifications made to the entire fleet of leased machines may be a change that indicates that the lessee would be reasonably certain to renew the lease of these machines.

Staff Analysis

47. Given the Boards' recent decision on reassessments of the lease term and purchase options, as well as the Boards' decision to permit application of the leases guidance at a portfolio level, the staff think that most of the concerns about reassessment of the discount rate have been addressed.

48. The result of these decisions is that a lessee would be required to reassess the discount rate only infrequently—that is, only when a significant event or significant change in circumstances within the control of the lessee results in a change to the lease term or the assessment of purchase options. The staff continue to think that reassessment of the discount rate is appropriate in these circumstances for the reasons outlined above (which explains the Boards' rationale in the 2013 ED for requiring reassessment of the discount rate in these circumstances). For example, assume a lessee determines the original discount rate of a lease on the basis of a five-year lease term. The lease term is reassessed at the end of year 3 and the lessee then determines that the remaining lease term is 7 years (because it is reasonably certain it will exercise a five-year extension option at the end of year five). The staff think that the lessee should update the discount rate when the lease term is changed at the end of year 3 to reflect the updated remaining lease term of 7 years. The discount rate applied would then be determined consistently with the lease payments included in the lease liability.

49. Lessors would not reassess the discount rate because they would not reassess the lease term or whether the lessee is, or is not, reasonably certain to exercise an option to purchase the underlying asset.

50. The staff have recommended in the April 2014 Agenda Paper 3B/FASB Memo 278 that lessors should not reassess variable lease payments that depend on an index or a rate and that lessees should reassess variable lease payments that depend on an index or a rate only when the lease payments are reassessed for other reasons (that is, reassessment of the lease term or whether the lessee is, or is not, reasonably certain to exercise an option to purchase the underlying asset).

Similarly, the staff think that the Boards should not require lessees or lessors to reassess the discount rate whenever there is a change in a reference interest rate if variable lease payments are determined using that rate. The staff think that the costs to reassess the discount rate each time there is a change in a reference interest rate would exceed any possible benefits to users (regardless of the decision in Agenda Paper 3B/FASB Memo 278). Requiring reassessment in those circumstances would appear inconsistent with the decision to eliminate the requirement to reassess variable lease payments that depend on an index or a rate (if the Boards agree with the staff recommendation in Agenda Paper 3B/FASB Memo 278).

Staff Recommendation

51. In summary, the staff recommend that the Boards:

    (a) Not require reassessment of the discount rate for lessors

    (b) Require lessees to reassess the discount rate *only* when there is a change to either:

        (i) The lease term; or

        (ii) The assessment of whether the lessee is, or is not, reasonably certain to exercise an option to purchase the underlying asset.

Questions 2–3: Reassessment of the Discount Rate
Question 2 – Do the Boards agree with the staff recommendation that a lessor should not reassess the discount rate? Question 3 – Do the Boards agree with the staff recommendation that a lessee should reassess the discount rate only when there is a change in the lease term or the assessment of whether the lessee is, or is not, reasonably certain to exercise a purchase option?

FASB Only: Risk-Free Rate Accounting Policy Election for Nonpublic Entities

Summary of Proposals in the 2013 ED

52. The 2013 ED proposed a specified relief for lessees that are private companies and not-for-profit entities (collectively, nonpublic entities[3]) that would allow an accounting policy election for the initial and subsequent measurement of all lease liabilities. Under that election, those liabilities could be discounted using a risk-free rate determined using a period comparable to the term of the lease. Nonpublic entities that choose to apply this specified relief would be required to apply it to all leases and to disclose their policy election of this relief.

53. The FASB decided to provide this specified relief in response to concerns of nonpublic entities, including not-for-profit entities, that it would be too costly for some of them to identify an incremental borrowing rate that takes into account the credit of the lessee and the impact of the leased asset as collateral. For certain nonpublic entities, particularly those with little or no comparable borrowings, the costs to determine and audit their incremental borrowing rate would outweigh the incremental benefits of using that rate.

54. The FASB considered whether to permit nonpublic lessees to use a zero discount rate. However, several FASB members were concerned that the approach would completely ignore the time value of money. Some FASB members expressed the view that it was not necessary to provide specified reliefs because the discount rate may not be as critical to determining the lease classification as it is under existing U.S. GAAP. However, the FASB decided that the use of a risk-free rate would address the input from nonpublic entities to reach a reasonable balance between the costs and benefits while still recognizing the time value of money.

[3] An entity, except for a **public business entity**, a **not-for-profit entity** that has issued, or is a conduit bond obligor for, securities that are traded, listed, or quoted on an exchange or an over-the-counter market, or an employee benefit plan that files or furnishes financial statements to the SEC

Summary of Feedback Received on the 2013 ED

55. Only *some* constituents provided feedback on the proposals related to nonpublic entities in the 2013 ED.

56. Some nonpublic entities and accounting and advisory firms expressed support for the FASB's decision to permit nonpublic entities to use a risk-free discount rate to measure the lease liability. These constituents commented that this exception would help to reduce the costs of implementing the leases standard and provide flexibility to smaller companies who have limited resources.

57. The majority of constituents that provided feedback on the proposal, primarily preparers and accountancy bodies, expressed concerns about the proposals. These constituents, including some users, stated that:

    (a) Although use of a risk-free rate would provide some cost relief, it could lead to misstated lease liabilities that do not mirror the economic reality of the lease because it would overstate the lease liabilities as compared with using an incremental borrowing rate.

    (b) Nonpublic entities may have a higher incremental borrowing rate than an investment grade public entity, which further calls into question the use of a risk-free rate.

    (c) The financial information used to evaluate entities is the same whether the entity is public or private. Therefore, any reliefs are problematic because they decrease the consistency and comparability of financial reports.

    (d) This exemption would provide nonpublic entity competitors with an unfair advantage over their public entity counterparts because it would be less costly for nonpublic entities to implement the leases proposals.

58. Alternatively, some constituents, mainly preparers, suggest that the FASB instead allow nonpublic entities (a) to estimate their incremental borrowing rate if their

actual incremental borrowing rate is unknown or (b) to use the rate on their most recent line of credit or term loan agreement. These constituents think that this would provide better estimates of the lease liability and would still provide cost relief.

Staff Analysis and Recommendation

59. The staff recommend that the FASB retain the risk-free rate accounting policy election for nonpublic entities because it was a direct response to constituent concerns that would significantly reduce cost for nonpublic preparers. The staff think that the requirement for nonpublic entities that avail themselves of this policy election to disclose their election and apply it to all of their leases will allow users to adequately compensate for any comparability issues between entities that elect this option and those that do not.

60. The staff does not recommend extending the risk-free rate option to public companies for a variety of reasons, including:

    (a) The relief was specifically provided to nonpublic entities because of cost-benefit concerns associated with determining the incremental borrowing rate. Public companies have greater access to the information needed to determine an incremental borrowing rate and so a relief of this nature would not, in most cases, provide a similar benefit or reduce an equivalent cost.

    (b) Previous deliberations and staff analyses have indicated that when determining the discount rate, the Board prefers to use a rate that is representative of the economics of the lease. The use of a risk-free rate among public companies would deemphasize the economics of the transaction in situations where it may have been equivalently cost efficient to emphasize the economics.

    (c) Because the risk-free rate is unadjusted for credit risk, it is smaller than the incremental borrowing rate. As a result, lease liabilities calculated

with a risk-free rate will be larger. The staff think that public companies would not, in practice, use an option that records larger lease liabilities.

Questions 4–5: Risk-Free Rate Accounting Policy Election for Nonpublic Entities

Question 4 – Does the FASB agree with the staff recommendation to retain an accounting policy election for nonpublic entity lessees to use a risk-free discount rate for all of their leases?

Question 5 – Does the FASB agree with the staff recommendation not to extend the accounting policy election to public business entities?

Appendix A: Illustrative Examples

A1. **Example One: The Rate the Lessor Charges the Lessee Is Readily Available**

Orange Co., a publicly traded hospitality company in Las Vegas, leases a gulfstream jet for 8 years from a major airplane lessor. Total lease payments amount to CU500,000. In the lease contract, the lessor provides information about the interest rate implicit in the lease (5 percent). Orange Co. is AA rated by S&P and actively raises debt in the corporate bond market. Based on its recent activity, Orange Co. would have had to pay an interest rate of 5.5 percent to borrow a similar amount over eight years. Eight-year AA-rated corporate bonds are currently trading, on average, at 5.8 percent.

What discount rate should Orange Co. use to initially measure its lease liability?

In this scenario, the rate the lessor charges the lessee is readily determinable. Therefore, Orange Co. should use 5 percent as the discount rate in this lease.

A2. **Example Two: Determining the Incremental Borrowing Rate**

Maize Co., a publicly traded automobile company, leases an office in Detroit for 10 years. Total lease payments amount to CU1,000,000. The lease contract does not provide information about the interest rate implicit in the lease and Maize Co. does not have other information upon which it could readily determine the rate the lessor is charging. Maize Co. is BBB rated by a credit rating agency and actively raises debt in the corporate bond market. Based on its recent activity, Maize Co. would have had to pay an interest rate of 7 percent to borrow a similar amount over 10 years. Ten-year BBB-rated corporate bonds are currently trading, on average, at 7.5 percent. Ten-year zero-coupon U.S. Treasury instruments are currently yielding 2.7 percent.

What discount rate should Maize Co. use to initially measure its lease liability?

In this scenario, the rate the lessor charges the lessee is not readily determinable. However, because Maize Co. actively participates in the corporate bond market, it

is able to determine the rate at which it could have borrowed the funds needed to purchase an asset with a similar value to that of the ROU asset over a similar term. Therefore, 7 percent is Maize Co.'s incremental borrowing rate, which would be used as the discount rate for this lease.

A3. **Example Three: Absence of Key Information**

Purple Co., a publicly traded Broadcasting Company, leases an office in Baltimore for 15 years. Total lease payments amount to CU10,000,000. The lease contract does not provide information about the interest rate implicit in the lease and Purple Co. does not have other information upon which it could readily determine the rate the lessor is charging. Purple Co. is not rated and does not actively raise debt in the corporate bond market. However, Purple Co.'s banker informs the CFO that its credit risk is similar to companies rated in the AA range. Fifteen-year AA-rated corporate bonds do not exist, but 10-year and 20-year AA-rated corporate bonds are traded, on average, at 3.41 percent and 4.31 percent, respectively.

What discount rate should Purple Co. use to initially measure its lease liability?

In this scenario, Purple Co. cannot readily determine the rate the lessor charges the lessee. It also is not active in the corporate bond market and is not rated by a rating agency. However, based on its knowledge of the business, management concludes that an AA rating is a reasonable proxy for its credit rating. Because the lease term is 15 years and 15-year AA corporate bonds are not quoted on an exchange, management needs to impute a reasonable interest rate based on its data. In this case, 3.86 percent (the average of the two rates) is a reasonable imputed rate. Thus, Purple Co. determines that 3.86 percent is its incremental borrowing rate, which would be used as the discount rate in this lease.

A4. **Example Four: Portfolio Approach with Centralized Treasury Operations**

Scarlet Co., a publicly-traded technology company headquartered in Columbus, is the parent of several consolidated subsidiaries in Europe and Asia. Scarlet Co.

recently expanded the cloud computing side of its business and, as a result, had two of its consolidated subsidiaries, A and B, lease large computer servers in their respective locations. Throughout the current quarter, Subsidiaries A and B entered into a total of 400 individual server leases, each with terms ranging between 4 and 5 years and total lease payments ranging between CU60,000 and CU100,000 depending on their hardware capacity. In aggregate, total lease payments for these leases amount to CU30,000,000.

The individual lease contracts do not provide information about the interest rate implicit in the lease and neither Scarlet Co. nor its subsidiaries have other information upon which it could readily determine the rate the respective lessors are charging. Scarlet Co. is BBB rated and actively raises debt in the corporate bond market. Subsidiaries A and B are both unrated and do not actively engage in treasury operations in their respective markets. Based on its credit rating, Scarlet's Co.'s incremental borrowing rate on CU60,000 - CU100,000 (the range of lease payments on each of the 400 server leases) would be approximately 4 percent. Scarlet notes that five-year zero-coupon U.S. Treasury instruments are currently yielding 1.7 percent (a risk-free rate). Because Scarlet Co. conducts its treasury operations centrally (that is, at the consolidated group level), it is reasonably assumed that consideration of the group credit standing factored into how each lease was priced.

What discount rate should Scarlet Co. use to initially measure its lease liability?

In this scenario, Scarlet Co. has two consolidated subsidiaries that engage in leasing activity. Scarlet Co. can simplify the determination of the discount rate for the 400 individual server leases entered into on different dates throughout the quarter by using a portfolio approach. Because (a) the new leases in the current quarter are all of similar terms (five years), and (b) Scarlet's credit rating and the interest rate environment were stable during the quarter, Scarlet Co. can apply a single discount rate to the portfolio of new leases. Scarlet Co. is a public entity; therefore, it cannot use a risk-free discount rate (permitted for U.S non-public

entities). Because the pricing of the lease is assumed to be influenced by the credit standing and profile of Scarlet Co., rather than Subsidiaries A or B, Scarlet's incremental borrowing rate of 4 percent can be used as the discount rate for each of the 400 leases of both subsidiaries. This would be the case regardless of whether Scarlet Co. or each of the Subsidiaries tracks the leases and regardless of whether the leases are recorded individually (that is, as 400 separate leases) or as 1 aggregate unit of account.