IFRS

STAFF PAPER

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IFRS® Interpretations Committee meeting

Project	**Lessee's incremental borrowing rate (IFRS 16)**		
Paper topic	Initial Consideration		
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Introduction

1. The IFRS Interpretations Committee (Committee) received a submission about the definition of a lessee's incremental borrowing rate in IFRS 16 *Leases*. The submitter asks whether a lessee's incremental borrowing rate must reflect the interest rate in a loan with both a similar maturity to the lease and a similar payment profile to the lease payments.

2. The objective of this paper is to:

   (a) provide the Committee with a summary of the matter;

   (b) present our research and analysis; and

   (c) ask the Committee whether it agrees with our recommendation not to add the matter to its standard-setting agenda.

Structure of the paper

3. This paper includes:

   (a) background information;

   (b) outreach;

   (c) staff analysis; and

(d) staff recommendation.

4. There are two appendices to this paper:

   (a) Appendix A—proposed wording of the tentative agenda decision.

   (b) Appendix B—submission.

Background information

5. Appendix A to IFRS 16 defines a lessee's incremental borrowing rate as:

   > 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.

6. The submitter explains that loans are generally either (a) amortising loans—paid down over time (principal and interest); or (b) bullet repayment loans—interest paid over time with a single bullet payment of the principal at the end of the loan. Interest rates for bullet repayment loans might often be higher than those for amortising loans.

7. The submitter asks whether a lessee's incremental borrowing rate must reflect the interest rate in a loan with both a similar maturity to the lease and a similar payment profile to the lease payments, or instead whether it is sufficient for the lessee's incremental borrowing rate to reflect the interest rate in a loan with a similar maturity to the lease.

8. Appendix B to this paper reproduces the submission, which provides further background information.

Outreach

9. We decided not to perform outreach on this submission for a number of reasons:

   (a) We are already aware that the determination of the discount rate applied to leases could have a material effect on the many entities that enter into such contracts. The Board's effects analysis on IFRS 16 identified the prevalence of leases and the expected widespread effect of recognising all leases (other than short-term leases and leases of low-value assets) on the balance sheet. A lessee is required to determine a discount rate for all leases recognised on its balance sheet. We expect a lessee to use its incremental borrowing rate in measuring most lease liabilities. This is because we think that, often, a lessee will be unable to readily determine the interest rate implicit in a lease. We are also aware that, for some leases (and in particular long-term leases), even small changes in the discount rate could result in materially different amounts being recognised as lease liabilities. Consequently, we did not need to perform outreach to conclude that determining a lessee's incremental borrowing rate could have a material effect on entities affected.

(b) The submission relates to the application of IFRS 16 and, in the light of its effective date (annual reporting periods beginning on or after 1 January 2019), there is likely to be little observable practice at this time. The definition of a lessee's incremental borrowing rate in IFRS 16 is similar to that in IAS 17 *Leases* (ie IAS 17's definition of the lessee's incremental borrowing rate refers to the rate the lessee would incur to borrow over a similar term and with a similar security). We therefore considered whether it would be beneficial to perform outreach on the application of IAS 17's definition of the lessee's incremental borrowing rate. However, applying IAS 17 a lessee was required to determine a discount rate only for leases classified as finance leases, whereas applying IFRS 16 a lessee determines a discount rate for all leases (other than short term leases and leases of low-value assets). The Board's effects analysis on IFRS 16 estimated that over 85% of total lease commitments related to operating leases, and thus were not recognised on a lessee's balance sheet applying IAS 17. We saw little benefit in performing outreach in relation to the application of IAS 17 because the population of lease contracts for which a discount rate was determined applying IAS 17 is much smaller than that applying IFRS 16.

Staff analysis

What IFRS 16 says

The definition of a lessee's incremental borrowing rate

10. As noted above, Appendix A to IFRS 16 defines a lessee's incremental borrowing rate as:

> 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.

11. Although there is discussion in the Basis for Conclusions (see below), IFRS 16 includes no further requirements (either in the body of the Standard or as application guidance) regarding a lessee's incremental borrowing rate.

When does a lessee apply its incremental borrowing rate?

12. IFRS 16 requires a lessee to measure lease liabilities on a discounted basis. Paragraph 26 of IFRS 16 states that:

> At the commencement date, a lessee shall measure the lease liability at the present value of the lease payments that are not paid at that date. The lease payments shall be discounted using the interest rate implicit in the lease, if that rate can be readily determined. If that rate cannot be readily determined, the lessee shall use the lessee's incremental borrowing rate.

13. Consequently, a lessee uses its incremental borrowing rate in measuring a lease liability when the interest rate implicit in the lease cannot be readily determined.

14. When developing IFRS 16, the Board expected a lessee to often use its incremental borrowing rate in measuring a lease liability. The Board noted in paragraph BC161 that 'it is likely to be difficult for lessees to determine the interest rate implicit in the lease for many leases, particularly those for which the underlying asset has a significant residual value at the end of the lease'. This is because, in addition to factors such as the credit standing of the lessee and the length of the lease, 'the interest rate implicit in the

lease is generally also affected by a lessor's estimate of the residual value of the underlying asset at the end of the lease, and may be affected by taxes and other factors known only to the lessor, such as any initial direct costs of the lessor'.

The Board's rationale and the outcome of applying the definition

15. The Board explained in paragraph BC160 its objective in specifying the discount rate to apply to a lease—ie 'to specify a rate that reflects how the contract is priced'. This is why IFRS 16 requires the use of the interest rate implicit in the lease if that rate is readily determinable. However, the Board acknowledged that it might often be difficult for a lessee to determine the interest rate implicit in the lease. The Board therefore decided to require the use of the lessee's incremental borrowing rate when the interest rate implicit in the lease is not readily determinable.

16. The Board's objective of reflecting how the contract is priced is also the reason that the Board defined a lessee's incremental borrowing rate 'to take into account the terms and conditions of the lease' (paragraph BC162). This means that the lessee's incremental borrowing rate is a lease-specific rate—it is not, for example, the weighted-average cost of capital or similar rate determined for the lessee at an entity or group level. The definition takes into account the terms and conditions of the particular lease by referring to 'similar term', 'similar security', 'an asset of a similar value to the right-of-use asset' and 'in a similar economic environment'.

17. Accordingly, in determining its incremental borrowing rate for a lease, as set out in the definition the lessee considers the terms and conditions of the lease and determines a rate that reflects the rate it would have to pay to borrow:

    (a) over a similar term to the term of the lease;

    (b) with a similar security to the security (or collateral) in the lease;

    (c) the amount needed to obtain an asset of a similar value to the right-of-use asset arising from the lease; and

    (d) in a similar economic environment to that of the lease.

Determining the rate involves estimation

18. Determining a lessee's incremental borrowing rate for any lease involves estimation—ie it is not an exact science. A lessee determines its incremental borrowing rate only when the interest rate implicit in the lease is not readily determinable. A lessee's incremental borrowing rate reflects what the lessee 'would have to pay', not what it has paid. Judgement is involved in estimating the rate.

19. The Board's explanation in paragraph BC162 highlights the estimation involved in determining a lessee's incremental borrowing rate:

> The IASB noted that, depending on the nature of the underlying asset and the terms and conditions of the lease, a lessee may be able to refer to a rate that is readily observable as a starting point when determining its incremental borrowing rate for a lease (for example the rate that a lessee has paid, or would pay, to borrow money to purchase the type of asset being leased, or the property yield when determining the discount rate to apply to property leases). Nonetheless, a lessee should adjust such observable rates as is needed to determine its incremental borrowing rate as defined in IFRS 16.

The maturity of the lease and the payment profile of the lease payments

20. The submitter asks a very specific question about the determination of a lessee's incremental borrowing rate, ie whether the rate must reflect both the maturity of the lease as well as the payment profile of the lease payments. In asking this question, the submitter highlights that the payment profile of a loan can affect the rate a borrower would have to pay—ie an entity might often have to pay a higher rate for a bullet repayment loan than for an amortising loan. The submitter says a lease liability with regular lease payments over the lease term is akin to an amortising loan.

21. We think it is clear in the definition of a lessee's incremental borrowing rate that the rate is determined to reflect the maturity of the lease—or, in the words of IFRS 16, the lease term. The definition refers to 'over a similar term', which in our view refers to a term similar to the lease term.

22. The definition does not, however, refer to the payment profile of the lease payments. Because of this, we think the submitter is asking for a degree of precision in applying the definition that goes beyond the definition itself.

23. The Board explained in paragraph BC162 that it decided to define a lessee's incremental borrowing rate to take into account the terms and conditions of the lease. In that paragraph, the Board went on to explain that, when determining its incremental borrowing rate, a lessee may be able to start with a readily observable rate, and then adjust that rate as is needed to determine its incremental borrowing rate as defined in IFRS 16. We think this paragraph explains the Board's intention when developing the definition of incremental borrowing rate, which was for a lessee to start with the best information it has available and adjust accordingly.

24. We think in many cases a lessee would refer to a readily observable amortising loan rate as the starting point when determining its incremental borrowing rate for a lease. Consequently, a lessee's incremental borrowing rate might often be similar to the interest rate in a loan that, among other terms and conditions, has a similar payment profile to the lease payments. Nonetheless, we think the words in IFRS 16 do not require this in every case. We also think there are many factors to consider in determining a lessee's incremental borrowing rate, and it is potentially misleading to discuss one factor in isolation of all others.

25. Consequently, we would expect a lessee to consider the terms and conditions of a lease and determine a rate that reflects the factors listed in the definition of a lessee's incremental borrowing rate as described in paragraph 17 of this paper.

26. We think to go further in our views or conclusions than what is said in paragraph 17:

    (a) is not necessary—ie the definition of a lessee's incremental borrowing rate provides an adequate basis for an entity to determine its incremental borrowing rate; and

    (b) would go beyond the Board's decisions regarding the lessee's incremental borrowing rate.

27. In reaching our conclusion, we note that the Board decided not to provide application guidance with respect to the lessee's incremental borrowing rate. In our view, this was

because the Board thought that (a) the definition itself would provide an adequate basis for an entity to determine the rate; and (b) to provide application guidance could create more questions than answers.

Staff Conclusion

28. Having analysed the definition of a lessee's incremental borrowing rate in IFRS 16 (paragraphs 10-27 of this paper), we have concluded that the question in the submission is asking for a degree of precision in applying the definition that goes beyond the definition itself.

29. IFRS 16 does not explicitly require a lessee to determine its incremental borrowing rate to reflect the payment profile of the lease payments. Nonetheless, a lessee considers the terms and conditions of a lease and applies judgement in estimating its incremental borrowing rate as defined in IFRS 16. In doing so, a lessee might often refer as a starting point to a readily observable rate for a loan with a similar payment profile to that of the lease, and then adjust that rate as is needed to determine its incremental borrowing rate.

30. We think the definition of a lessee's incremental borrowing rate in IFRS 16 provides an adequate basis for a lessee to determine the rates to apply to its leases. This is consistent with the Board's decision not to include application guidance in IFRS 16 on this topic.

Question 1 for the Committee
Does the Committee agree with our analysis of the definition of a lessee's incremental borrowing rate in IFRS 16, outlined in paragraphs 10-30 of the paper?

Should the Committee add this matter to its standard setting agenda?

Is it necessary to add to or change IFRS Standards to improve financial reporting?[1]

31. Based on our analysis, we think the definition of a lessee's incremental borrowing rate in IFRS 16 provides an adequate basis for an entity to determine the rates to apply to its leases when the interest rate implicit in the lease is not readily determinable.

Staff recommendation

32. On the basis of our assessment of the Committee's agenda criteria in paragraphs 5.16–5.17 of the *Due Process Handbook* (discussed in paragraph 31 of this paper), we recommend that the Committee does not add this matter to its standard-setting agenda. Instead, we recommend that the Committee publish an agenda decision that explains the definition of a lessee's incremental borrowing rate.

33. Appendix A to this paper sets out the proposed wording of the tentative agenda decision.

Questions 2 and 3 for the Committee
2. Does the Committee agree with our recommendation not to add this matter to its standard-setting agenda? 3. Does the Committee have any comments on the proposed wording of the tentative agenda decision set out in Appendix A to this paper?

[1] Paragraph 5.16(b) of the *Due Process Handbook*.

Appendix A—Proposed wording of the tentative agenda decision

Lessee's incremental borrowing rate (IFRS 16 *Leases*)

The Committee received a request about the definition of a lessee's incremental borrowing rate in IFRS 16. The request asked whether a lessee's incremental borrowing rate must reflect the interest rate in a loan with both a similar maturity to the lease and a similar payment profile to the lease payments.

Appendix A to IFRS 16 defines a lessee's incremental borrowing rate as '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'. The lessee's incremental borrowing rate is therefore a lease-specific rate that the Board defined 'to take into account the terms and conditions of the lease' (paragraph BC162).

Applying IFRS 16, a lessee uses its incremental borrowing rate in measuring a lease liability when the interest rate implicit in the lease cannot be readily determined (paragraph 26 of IFRS 16). In determining its incremental borrowing rate, the Board explained in paragraph BC162 that, depending on the nature of the underlying asset and the terms and conditions of the lease, a lessee may be able to refer to a rate that is readily observable as a starting point. A lessee would then adjust such an observable rate as is needed to determine its incremental borrowing rate as defined in IFRS 16.

The Committee observed that the definition of a lessee's incremental borrowing rate requires a lessee to determine its incremental borrowing rate for a particular lease considering the terms and conditions of the lease, and determine a rate that reflects the rate it would have to pay to borrow:

(a) over a similar term to the lease term;

(b) with a similar security to the security (collateral) in the lease;

(c) the amount needed to obtain an asset of a similar value to the right-of-use asset arising from the lease; and

(d) in a similar economic environment to that of the lease.

IFRS 16 does not explicitly require a lessee to determine its incremental borrowing rate to reflect the interest rate in a loan with a similar payment profile to the lease payments. Nonetheless, the Committee observed that, in applying judgement in determining its incremental borrowing rate as defined in IFRS 16, a lessee might often refer as a starting point to a readily observable rate for a loan with a similar payment profile to that of the lease.

The Committee concluded that the principles and requirements in IFRS 16 provide an adequate basis for a lessee to determine its incremental borrowing rate. Consequently, the Committee [decided] not to add the matter to its standard-setting agenda.

Appendix B—Submission

B1. We have reproduced the submission below, and in doing so deleted details that would identify the submitter of this request.

Suggested agenda item: Lessee's incremental borrowing rate under IFRS 16

It has come to our attention that there are divergent views on the appropriate interpretation of the words 'over a similar term' in the definition of the lessee's incremental borrowing rate (IBR) in Appendix A to IFRS 16 *Leases*. We are seeking clarification of the issue detailed below by the Committee.

Background

As required by IFRS 16.26, when the interest rate implicit in the lease cannot be readily determined, the lessee uses the lessee's incremental borrowing rate (IBR) to measure the lease liability. Under IFRS 16, the IBR is defined as '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'.

Loans are generally either:

- Amortising loans – paid down over time (principal and interest); or
- Bullet repayment loans – interest paid over time with a single bullet payment of the principal at the end.

Often, the interest rates for bullet repayment loans are higher than those for amortising loans with the same initial principal amount and term. A lease liability with regular lease payments over lease term is akin to an amortising loan.

In practice, the IBR is often determined starting with a risk free rate for the economic environment and currency such as a bond rate.

Question

Should the IBR reflect the interest rate on loans with similar payment profile and maturity or is it sufficient for the loans to have the same ultimate maturity as the lease?

View 1: The IBR should reflect the interest rate in loans with similar payment profile and maturity as the lease payments.

Proponents of this view believe the ‘similar term’ should be considered to include the payment profile of the lease payments. Applying such an approach would reflect the individual payment profile of a lease such as rent-free periods, or increasing payments, and would result in different IBR for leases of the same lease term but different payment schedules.

Proponents of this view might use the weighted average repayment maturity of the lease payments as an approximation of ‘similar term’. For example, if a lease has a 10-year lease term with equal annual payments in arrears, the weighted average maturity is 5.5 years. The IBR would be based on a 5.5-year bond.

Other proponents of this view would use the yield curve corresponding to the repayment structure of the lease agreement as a more precise reflection of the payment profile. They would then use the interest rate yield curve to assign an appropriate rate to each repayment (cash flow) separately. The first repayment would be discounted using the 1-year yield, the second repayment should be discounted using the 2-year yield and so on.

Supporters of this view note that this approach is also used for mortgage loan valuations – representing the same repayment structure as a lease agreement. This approach reflects the repayment structure and most closely reflects how an equivalent borrowing would be priced.

View 2: It is sufficient for the IBR to reflect the interest rate in loans with the same maturity as the lease.

Proponents of this view believe that although IFRS 16 requires a lease to be accounted for as if it has borrowed to fund the purchase of an asset equal to the right-of-use asset, there is no guidance requiring the payment structure to be considered. Further they believe that the IBR is intended to be a simplification because the lessee could not readily determine how the specific lease was priced, hence simply using the lease term without consideration of the payment profile as the ‘similar term’ is appropriate.

For example, if a lease has a 10-year lease with equal annual payments, the IBR would reflect a 10-year bond.

In addition, the IASB staff paper produced in April 2014 during development of the Standard, appears to support this view.

Reasons for the Committee to address the issue

The calculation of lease liabilities is very sensitive to changes in discount rate. There is currently diversity in views as to whether IFRS 16 requires use of the lease term as defined to be the ‘similar term’ referred to in the IBR definition, or whether ‘similar term’ should reflect the specific lease payment profile. This diversity is demonstrated in views expressed in the published literature of some of the large accounting firms.

We believe that clarity could be provided by means of a minor amendment to IFRS 16.

In addition, the issue is not related to a Board project that is expected to be completed in the near future.

For these reasons, we believe that this issue meets the criteria for acceptance onto the Committee’s agenda.