RSM INSIGHT: Determining the Discount Rate Under IFRS 16

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Determining the discount rate under IFRS 16

Many companies have underestimated the impact of the adoption of IFRS 16 *Leases* and the key judgements involved in the transition to the new leasing standard.

The general consensus amongst IFRS reporters is that the impact of IFRS 16 is simply balance sheet recognition of leases and that it's not as technically complex to adopt compared to IFRS 15 *Revenue from Contracts with Customers* or IFRS 9 *Financial Instruments.* IFRS 16 largely results in recognition of a lease liability and corresponding right-of-use asset leases, for most historic operating leases, but the challenges associated with determining the transitional adjustments and on-going recognition of new leases are often underestimated.

1. Determining the discount rate

Determining the discount rate is a key challenge and judgement in the adoption and on-going application of IFRS 16. In terms of the determination of the discount rate, IFRS 16 Basis for Conclusions 160 notes that:

"The IASB's objective in specifying the discount rate to apply to a lease is to specify a rate that reflects how the contract is priced".

The rate used per the standard is:

- the rate implicit in the lease, if readily determinable; or
- the lessee's incremental borrowing rate.

It is clear from the objective and the "choice" above that the rate implicit in the lease should be used if it can be readily determined. Only if it can't be determined, can the lessee's incremental borrowing rate be used instead.

2. Rate implicit in the lease

The rate implicit in the lease, which is the first approach in the hierarchy in the standard for determining discount rates, is defined as the rate of interest that causes the present value of:

(a) the lease payments and

(b) the unguaranteed residual value

to equal the sum of

(i) the fair value of the underlying asset; and

(ii) any initial direct costs of the lessor.

The rate implicit in the lease reflects how the lease contract is priced and meets the objective of a discount rate for the lease liability.

For leases of equipment, the rate implicit in the lease is typically explicitly stated in the lease agreement. For property leases, the key challenge for entities is determining all the variables within the calculation. As the rate is a lessor specific rate, entities applying IFRS 16 will typically only know the lease payments. However, the other inputs into the calculation can be readily determined by external valuers, meaning that over time there may be a shift towards the discount rate being calculated as the rate implicit in the lease.

3. Approaches to determining the lessee's incremental borrowing rate

Where the rate implicit in the lease cannot be readily determined the lessee's incremental borrowing rate should be used. This is defined in IFRS 16 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 basis for conclusions provides some guidance on how to determine the lessee's incremental borrowing rate:

> "…..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." IFRS 16 BC162

From this it is clear that the IASB intention is that the starting point to determining a lessee's incremental borrowing rate should be a readily observable rate which should then be adjusted to take into account the credit risk of the entity, asset security, funds and economic environment.

There are two possible approaches emerging in terms of calculating the incremental borrowing rate:

- top down approach – which starts with an entity specific rate e.g. existing bank borrowing, or an acknowledged bank rate; and
- bottom up approach - which starts with a risk-free rate.

There are challenges associated with both approaches in terms of the adjustments needed to determine the incremental borrowing rate of the entity. However, out of the two possible approaches, the top down approach is typically more accurate as it considers:

- credit rating of the entity;
- security of the asset;
- loan to value ratio for secured borrowings;
- funds and repayment profile; and
- economic environment.

Additionally, the top down approach starts with entity specific observable data and hence generally requires less modification and more closely aligns to the requirements of the standard.

The bottom up approach which starts with a risk-free rate will need to be adjusted to consider the following:

- repayment profile of the lease (over the length of the lease) compared to risk-free rates which assume repayment of the principal at maturity;
- credit spread of the lessee; and
- asset specific adjustments

The main challenge with a bottom up approach is the availability of readily observable data for the asset specific adjustments i.e. the quality of the security of the asset and the nature of the specific asset.

4. What about property yields?

Whilst the basis for conclusions does note that property yields can be used as an input to determine a lessee's incremental borrowing rate, there are a number of challenges associated with their use. The first challenge is determining which property yield should be used as a starting point e.g. initial yield, equivalent yield or reversionary yield. Once the relevant property yield has been determined, the next challenge is how to adjust for the following:

- length of lease;

- difference in credit rating of lessee and tenants in the market;
- expectations about risks associated with the property's value unrelated to lessee's performance; and
- currency of lease.

In practice the following hierarchy is establishing when calculating the discount rate for IFRS 16:

1. Rate implicit in the lease where it is readily determinable;
2. Incremental borrowing rate using the top down approach where entity specific observable data is available;
3. Incremental borrowing rate using the bottom up approach where entity specific observable data is not available.

5. Transition approach choices

IFRS 16 provides two transition choices: full retrospective or modified retrospective.

The modified retrospective approach has the advantage of having several practical expedients and also mandates that the discount rate to calculate the lease liability should be the lessee's incremental borrowing rate at the date of transition. However, the full transition approach results in a lower income statement impact in subsequent periods due to the profile of unwinding of the discount on the lease liability. Boards and management should determine which transitional approach is most suitable for the business, considering both the ease of transition and the financial impact of both approaches.

The modified retrospective approach provides two choices in terms of how to measure the right-of-use asset:

- its carrying amount as if IFRS 16 had been applied since the start of the lease but discounted using the lessee's incremental borrowing rate at the date of initial application; or
- an amount equal to the lease liability, adjusted by the amount of any prepaid or accrued lease payments recognised in the statement of financial position immediately before the date of initial application.

The measurement choice is available on a lease by lease basis. Where entities chose a mixed approach to measuring the right-of-use asset, it is best practice to disclose and explain the reasons for the mixed measurement approach.

6. Impact of transitional approach on discount rate

The transitional approach will determine the discount rate used to measure the lease liabilities under IFRS 16. Companies adopting the full retrospective approach should calculate discount rate using:

- the rate implicit in the lease, if readily determinable; or
- the lessee's incremental borrowing rate.

i.e. the same as discussed above.

For entities adopting modified retrospective transition, the lessee's incremental borrowing rate must be used to determine the discount rate. As discussed above, this can be done using the hierarchy of:

1. Incremental borrowing rate using the top down approach where entity specific observable data is available;
2. Incremental borrowing rate using the top down approach where entity specific observable data is not available.