ASC 842: Calculating the incremental borrowing rate as a lessee

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In most situations, the new lease accounting guidance requires recognition by a lessee of a right-of-use asset and a lease liability on its balance sheet. The lease liability is measured as the present value of remaining lease payments. In general, each lease will require its own discount rate unless the lessee has elected to apply a portfolio approach. The discount rate determination is outlined under a specific framework, but it still requires critical judgments and a thorough process. Conclusions based upon a discount rate that is based on a lender's quote or an existing borrowing facility are typically not appropriate. These items should only be considered as data points. The lender quotes and rates on existing borrowing facilities on a stand-alone basis typically do not meet all of the criteria for a discount rate as further indicated below.

This paper presents the requirements for developing the discount rate according to the new lease accounting guidance, with a focus on determining the incremental borrowing rate for lessees.

What is the right discount rate?

The lessee should use the interest rate implicit in the lease (IRIL) as the discount rate to determine its lease liability, if the information is readily available. However, given the IRIL consists of several lessor-based components,[1] the lessee is highly unlikely to have the information required to calculate the IRIL. Unless certain policy elections are made (as described below) in most cases a lessee will be required to determine its incremental borrowing rate (IBR) and use this rate to determine the present value of its lease liability.

Policy election: It should be noted that a nonpublic business entity is permitted to use a risk-free discount rate for its leases comparable to corresponding lease teams. This is a policy election made by the entity.

What is the IBR?

According to the Master Glossary of the ASC, the definition of the IBR is the following: "The rate of interest that a lessee would have to pay to borrow on a collateralized basis over a similar term an amount equal to the lease payments in a similar economic environment."

The lease accounting guidance provides limited transparency regarding the calculation of the IBR, but the factors that require consideration can be deciphered from the definition above. The following sections detail the key components and considerations when determining the IBR and developing quantitative and qualitative support for the IBR.

1. The IRIL is defined as the rate of interest that causes the aggregate present value of (a) the lease payments and (b) the amount that a lessor expects to derive from the underlying asset following the end of the lease term to equal the sum of (1) the fair value of the underlying asset minus any related investment tax credit retained and expected to be realized by the lessor and (2) any deferred initial direct costs of the lessor.

Components of the IBR

The following components need to be considered and thoroughly documented when determining and documenting the IBR:

- Lessee-specific credit risk
- Amount of the lease payments
- Collateralized nature of the lease
- Quality of the lessee's collateral
- Alignment of the borrowing term and lease term
- Economic environment of the lease and foreign-currency considerations

The evaluation of each of these components requires significant professional judgment and proficiency. One must carefully consider the components listed below and seek assistance from RSM's valuation team due to the nuances and differing interpretations.

Lessee-specific credit risk

The IBR is lessee-specific. The creditworthiness of the lessee, or the ability for the lessee to repay its debt obligations, is the base consideration for determining the IBR. If a credit rating from one of the major credit-rating agencies is available for the lessee, it should be considered in conjunction with data points (as described below) that are available to determine the base credit-risk profile of the lessee. Alternatively, if a credit rating for the lessee does not exist, a synthetic credit rating should be developed. A hypothetical credit rating for the lessee can be determined based on qualitative and/or quantitative measures. One example of a synthetic credit-rating model considers liquidity and solvency financial ratios in order to categorize the lessee into a hypothetical credit-rating group. Another method of estimating a synthetic credit rating includes performing a regression analysis of the lessee's financial metrics against a peer group of public debt issuers to determine the synthetic credit rating on a rank basis. Whether the credit rating is determined by a rating agency or synthetically by the specialist, this rating can be used as the starting point for the credit-risk component of the IBR.

If such data exists, one should consider adjusting the observed market credit risk to be applicable to the lessee. A generic yield curve is extracted from a market data source for the same credit rating, and the representative yield curve is the perceived market risk profile of the lessee based on similarly rated bonds. It's important to remember that a generic credit curve is an aggregate and mathematical compilation of yields in the market. Most often, individual constituents of that curve have yields above or below. If available, it's important to consider the lessee's yield compared to the generic curve. When applying a credit-spread adjustment to the IBR, one should consider the term structure of the IBR curve and the nature of credit spreads varying by term.

Additionally, the lessee credit risk should be carefully considered for all leases that require an IBR calculation for a company. Specifically, applying the corporate parent's credit-risk profile to one of its subsidiaries is generally appropriate if the corporate parent assumes a guarantor relationship with the subsidiary. This guarantor relationship can be described explicitly in the lease agreements or implicitly upon an understanding of the relationship between the two entities (i.e., if the corporate parent acts as the main treasury function for the subsidiary) . Assuming the corporate parent is the guarantor to one of its subsidiaries that entered a lease, it indicates that the corporate parent will assume the subsidiary's lease payments in the instance of a payment default by the subsidiary. Seek further guidance from our team and your auditors regarding the steps to determine if the guarantor relationship exists.[2]

Understanding the guarantor relationship is a critical step in determining the IBR because it affects the scope of work for lessees. For example, if a corporate parent guarantees the leases for all of its subsidiaries, then only the corporate parent's creditworthiness needs to be considered in the IBR calculation (not the subsidiaries' credit risk). The alternative scenario, where the corporate parent is not the guarantor for its subsidiaries, requires the development of a specific subsidiary's credit-risk profile in determining the IBR.

2. Accounting Standards Update (ASU) 2016-02, Leases (Topic 842). Example 842-20-55-20.

Amount of the lease payments

Since the discounted lease payments will be included on the balance sheet as a liability, they will have an impact on the amount of the lessee's debt obligations. To the extent that the lease payments have a significant impact on the capital structure of the lessee, one should consider the increased credit-risk profile due to this increase in debt obligations. On the other hand, if the amount of the lease payments is insignificant compared to the lessees existing debt obligations, a risk adjustment to consider this component may be negligible.

Collateralized nature of the IBR

The IBR is on a collateralized, or secured, basis. Therefore, the rate should reflect the belief that the lessee can pledge its assets in the instance that it defaults on its lease payments. This is unique compared to unsecured debt, which typically has no recourse when the obligor defaults.

Therefore, the IBR, on a secured basis, will typically command a lower rate of return compared to its unsecured counterpart. Market rates that reflect the lessee's credit-risk profile are generally on an unsecured basis. Therefore, an adjustment is needed to convert the market rates to reflect a secured borrowing rate for the lessee. Quantifying a secured adjustment should be specific to the lessee, if market rate data for the lessee is available. We believe that the secured adjustment is not specific to a leased asset, as market collateralized rate data specific to the leased asset is unlikely to be readily available, but rather the secured adjustment considers that the lease obligation is secured by the company's aggregate collateral. See the next section for additional commentary on lease asset-specific discussions.

Quality of the lessee's collateral

We believe that the IBR shall not necessarily be determined with consideration specific to the leased asset, but rather viewed on a holistic basis. An adjustment for the quality of the lessee's collateral should be based on whether the lessee has sufficient collateral, in aggregate, to pledge in order to meet its lease payments if a default were to occur.

Additionally, creditworthiness plays a role in the magnitude of this adjustment. For example, if a company has high creditworthiness, default is unlikely, and a scenario of attempting to recover the lessee's assets in the event of a default is nominal, having de minimis impact on the IBR. On the other hand, if a company has poor credit quality, and a lender contemplates that the lessee may not be able to meet its obligations, seizing its assets in order to fulfill the lease payments is a highly likely scenario. In such an instance, the quality of collateral may be a more important factor to the IBR and may need to be considered further.

Alignment of the borrowing term and the lease term

The term of the lease must also be taken into consideration when determining an appropriate IBR, as risks vary, depending on the length of time due to interest-rate risk and other factors that affect a yield curve's term structure. Depending on the cycle of the economy and the general shape of the interest-rate curve, the discount rate is expected to differ based on the term. The entity should consider this in the determination of the IBR in order to reflect the risk profiles of leases appropriately. In other words, a lease with one year remaining should have a different IBR than a lease with ten years remaining because the risks are different.

Economic environment of the lease and foreign-currency considerations

To the extent that country risk has not been included in the credit-risk profile, one should consider how the country's sovereign credit risk should be considered in the IBR. For instance, a lease that is entered into in a developed country will have a different risk profile than a lease that was entered into in an undeveloped country.

Sovereign credit risk

The guarantor relationship will need to be established when contemplating a sovereign credit-risk adjustment. If the corporate parent is the guarantor, then the corporate parent's credit risk should be included in the IBR, and one would not have to include the sovereign credit risk of the foreign subsidiary. However, if the foreign lessee is the obligor, then sovereign credit risk should be considered (if it hasn't been included in the foreign lessee's base credit rating already).

Foreign-currency considerations

In addition to the economic environment, one must consider that a foreign subsidiary's lease payments are typically denominated in the local currency. Thus, the discount rate applied to the foreign-currency lease payments should match the risk of the lease's currency denomination in order to discount the lease cash flows on the same basis. Even a guarantor is exposed to currency risk in which a lease payment may be higher or lower than projected due to currency rate fluctuations. One must consider the local currency along with inflation and other economic considerations. Isolating and applying these components may be difficult, but our team of specialists is here to help.

Reassessment of the discount rate—lessees

Generally, a reassessment of the discount rate is required if any of the above components have changed since the initial determination of the IBR. A modification to a lease's contractual terms would warrant the need to reassess the discount rate applied to a lease. In addition, market rates are not stagnant. As such, it's important to assess how to determine the IBR on a forward basis when new leases are entered into after the implementation date.

In summary, determining the IBR involves components that meet the requirements of the guidance, and they need to be diligently documented, derived and explained. As a result, rate quotes from banks and revolving lines of credit (only applicable for one time length) are points to consider in the IBR but will be difficult to solely rely upon as discount rates to apply to its leases.

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