In search of the discount rate

Challenges in implementing the new lease accounting requirements

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The new accounting standard IFRS 16 requires lessees to recognize assets and liabilities for most leases at the present value of the future lease payments. But, how is the discount rate determined in practice?

IFRS 16 *Leases* was issued by the International Accounting Standards Board (IASB) in January 2016 and will replace the current standard IAS 17 *Leases* for reporting periods beginning on or after 1 January 2019. The new accounting framework will no longer distinguish between operating and finance leases for lessees and thus bring most of the leases onto the balance sheet. Lessees will have to recognize a right-of-use asset and a corresponding lease liability, the latter being the present value of the future lease payments. The discount rate to be applied will be:

a) the interest rate implicit in the lease, if that rate can be readily determined; or

b) the lessee's incremental borrowing rate.

Based on our experience, it may in many circumstances be difficult to determine the interest rate implicit in the lease. We therefore would expect most entities to determine the discount rate based on their incremental borrowing rate. The standard defines this 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. What already sounds like a rather theoretical definition triggers, in our view, three main questions when applying this in practice:

1. Would a group entity apply different discount rates per subsidiary or one consistent discount rate for the entire group?

Generally, a discount rate has two main components: the risk free interest rate and a credit spread. While the risk free interest rate is linked to the respective currency of the cash flows (of the lease), the credit spread is directly linked to the credit quality of the lessee. Both components are impacted by the term of the lease agreement, usually, the longer the lease term, the higher the discount rate. In other words, there is no such thing as a discount rate per currency, but rather a discount rate curve linking the discount rate to the term of the lease.

Risk free interest rates per currency are easily observable in the market. In theory, each subsidiary would of course also have its own credit spread. However, in practice it may be difficult to determine the credit spread for a subsidiary, in particular if:

- the majority of the financing activities are centralized at group level; or
- the parent entity provides a guarantee of the lease payments of a subsidiary to the lessor.

In such situations it may appropriate to use a single discount rate curve per currency for the entire group taking into account the credit spread applicable to the entire group, subject to potential adjustments (see below).

2. Does the discount rate need to be adjusted based on the nature and quality of the underlying asset?

An adjustment to the lessee´s incremental borrowing rate may be necessary based on the underlying nature of the leased asset. The leased asset can be seen as a collateral to the lease liability, hence, increasing the credit standing of the lessee. A collateralized asset should result in a lower discount rate compared to an uncollateralized asset. In general, the higher the quality and liquidity of the leased asset, the lower the discount rate as it would work as a kind of guarantee for the lessor. The credit spreads determined based on the lessee's non-lease financing would in most cases not be collateralized. Thus, determining the lease discount rate on such uncollateralized credit spreads may require an adjustment to compensate for the risk resulting from the lease asset collateral.

In practice, an entity may need approximation techniques to determine the above adjustment.

3. How frequently does an entity need to re-assess its discount rate curves?

We expect entities to enter into new lease agreements on a frequent basis. In theory, the standard would of course require that the discount rate always be the rate which takes into account all the facts and circumstances as at the commencement date of the lease, e.g. the date it obtains the use of the underlying asset or in certain cases when there is a lease modification.

However, this may not prove to be very efficient in practice, particularly when a group enters into many lease contracts across several currencies and with various lease terms over a rather short period of time. In such situations, it could be suggested that an entity needs to strike a balance between operational simplification and compliance with the standard. The degree of simplification would always be entity specific and depend on the number and frequency of new lease contracts, the volatility of the underlying risk free rates as well as the credit spreads and ultimately, also the magnitude of lease contracts (i.e. how material the impact of the simplification would be on the entity's financial position).

Learn more

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