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Demystifying the new leasing standard

How to determine your discount rate for lease measurement

The new leasing standard ("ASC 842") dramatically increases the number of leases that companies may need to record on their balance sheets. This greatly amplifies the importance of accurately estimating lease discount rates, which can have a significant impact on your company's lease liabilities and right-of-use assets.

Under the new standard, every lease with a lease term of more than a year must be recorded on the balance sheet as a right-of-use (ROU) asset and a corresponding lease liability. The lease liability is measured by using an appropriate discount rate to calculate the present value of future lease payments.

Choosing an appropriate discount rate

Lessees are required to use the rate implicit in the lease (RIIL), if it can be readily determined. However, in order to determine the RIIL, a lessee needs to know several assumptions used by the lessor in pricing the lease, including the underlying asset's fair value, the estimated residual value of the underlying asset at the end of the lease, and any initial direct costs deferred by the lessor. In many cases, this information is not readily available to the lessee.

When the RIIL in the lease cannot be readily determined (which is generally the case), the lessee should use its incremental borrowing rate (IBR), which is the rate that the lessee would pay to borrow an amount equal to the lease payments on a collateralized basis over a similar term.

ASC 842 permits a lessee that is not a public business entity (e.g., private companies), as an accounting policy election, to use a risk-free discount rate as a practical expedient in lieu of its incremental borrowing rate when assessing lease classification and when measuring its lease liabilities. This policy election is by underlying asset class and would apply to all leases within that asset class for which the lessee cannot readily determine the rate implicit in the lease.

Connecting the dots — Use of a risk-free rate may have unintended consequences

While a private company lessee's use of a risk-free discount rate may reduce some of the complexities related to measuring its lease liabilities and ROU assets, there may be some unintended consequences. For example, using a risk-free discount rate would typically result in a lease liability and ROU asset that are larger than those that would have been calculated by using the lessee's incremental borrowing rate. This would also likely result in calculating a higher present value of the lease payments, which could impact the lease classification (e.g., classifying a lease as a finance lease when the practical expedient is used, whereas the lease would be classified as an operating lease if the practical expedient is not used).

Estimating lease discount rates can have a significant impact on your company's lease liabilities and right-of-use assets.

Further, there may be certain implications when a company plans on undertaking an initial public offering (IPO). For example, once a company (even if it qualifies as an emerging growth company (EGC) is considered a public business entity, it is no longer permitted to apply private-company accounting alternatives, including the use of practical expedients that are only available to private companies. Therefore, any previously elected private-company alternatives would need to be retrospectively eliminated from the company's historical financial statements before such statements can be included in its IPO registration statement. This includes the use of the risk-free rate under ASC 842. Therefore, an entity should use caution in using the risk-free rate to measure leases under ASC 842 if it expects that it may undergo an IPO or if it expects it would otherwise need to eliminate the effect of applying private-company accounting alternatives (e.g., if its financial statements will be included in another company's SEC filing as a significant acquiree or investee).

Confusion over collateral

For many companies, one of the biggest challenges in determining an appropriate IBR is establishing an efficient and effective process for estimating the rates that would be applicable for borrowings on a fully collateralized basis.

Many large businesses can secure financing based strictly on their credit rating and do not need to provide collateral. These companies do not tend to borrow on a collateralized basis, and thus it's not clear what their collateralized borrowing rate would be (or how adding collateral would affect their uncollateralized rate). Also, even for businesses that routinely borrow using collateral as security, the types of loans being secured—and the assumptions used (e.g., amount of collateral)—may be very different from those associated with their leases, making the rates difficult to compare. The process for determining IBRs should be repeatable and well documented so the calculations are consistent and well controlled.

The process should also be efficient so as not to create an overwhelming administrative burden. These attributes are especially important because a variety of IBRs may be needed for different types of leases and lease terms. In addition, a company's IBR can change over time and therefore needs to be updated periodically. Companies should develop a sound process to review and update their IBRs periodically as an updated IBR will be needed in certain scenarios (i.e., new leases, modifications, reassessment events). For example, a company that has significant leasing activity may find it efficient to update its IBRs on a quarterly basis so that the data is readily available to account for any new or changed leases over that period.

Solving the IBR problem

The good news is there are reasonable approximations, processes, and proxies that can be used to determine a collateralized IBR. Although a company's IBR is typically expressed as a single-point estimate, it may be developed using a number of different data sources with appropriate adjustments to establish a rate that is meaningful for its intended purpose. It is also important for a company to develop its IBR in accordance with the ASC 842 definition and document the process with reasonable rationale for the key inputs used and judgments made.

While there is no prescribed approach to estimating a company-specific IBR, there are a number of factors to consider. The credit quality of the entity should be analyzed to form a basis to develop appropriate borrowing rates. In addition, consideration should be given to the requirements within the guidance that the rates used reflect a secured, or collateralized, cost of borrowing. Most entities may need to develop a curve reflecting secured borrowing rates for varying tenors so that suitable rates can be applied to leases with different remaining lease terms. ASC 842 specifies that the rate used reflects a borrowing cost over a term equivalent to the lease term. In many cases, this may take the form of selecting or developing a rate curve based upon the credit quality of the entity, with an adjustment made for security.

It is important to note that subsidiaries may not necessarily default to using rates reflective of the parent's credit standing—generally speaking, a subsidiary should only take into account parent credit if the parent guarantees the lease or there is other evidence that the negotiations and pricing of the lease considered the parent company's credit standing (e.g., there being a centralized treasury function). Accordingly, the organizational structure may necessitate separate consideration of the credit quality of certain subsidiaries in addition to that of the parent. Further, if a company is party to leases denominated in foreign currencies, additional adjustments to the established base rates may need to be considered in order to capture any applicable currency and/or political risks inherent in each jurisdiction. For a multinational company, the result is likely to include a variety of IBR curves that reflect different combinations of credit, currency, and political risks that will be applied to leases based on their key characteristics.

In summary, the determination of an appropriate IBR involves multiple inputs and judgments. Some may start with a base rate that reflects general factors such as overall economic conditions, currency volatility, and the broad interest rate environment for various types of securities and terms and then adjust for entity-specific factors such as credit risk. Others may start with bond rates that already incorporate a credit factor. In all cases, things like lease term/tenor, level of indebtedness, payment structure and timing, and parent/subsidiary structure should be considered. Finally, entities may need to apply an adjustment for full collateralization that reflects the liquidity of the collateral chosen (e.g., the more liquid the collateral, the larger the potential adjustment to the rate).

In practice, the model's underlying details can be quite complex and vary significantly from one business to the next. However, the bottom line is that the IBR problem—although complex and challenging—is one that can be solved both effectively and efficiently with the right tools, data, and experience.

The good news is there are reasonable approximations, processes, and proxies that can be used to determine a collateralized IBR.

Frequently asked questions

Can our collateralized rate be higher than our general unsecured borrowing rate?

No. The starting point for determining collateralized IBR is the company's general unsecured borrowing rate, given the term of the lease and amount of the lease payments. That base rate is then adjusted to reflect the effect of collateral. Since adding collateral only improves the lender's level of security, it should lower the applicable borrowing rate.

What collateral should we use when estimating an IBR?

It would generally be acceptable to use the leased asset itself as the assumed collateral. This is consistent with most collateralized borrowings whereby the lender can foreclose on the asset that was purchased with the proceeds of the loan. However, based on discussions with FASB and SEC staff, we understand that other forms of collateral can also be used if they are likely to be accepted by a lender. For example, a lender that requires collateral would likely accept US Treasuries instead of a fixed asset (e.g., building, equipment) because the Treasuries are more liquid and therefore offer more security to the lender. In general, lender acceptance would likely depend on the proposed collateral's level of liquidity relative to the leased asset. Assets that are more liquid than the leased asset would likely be accepted as collateral, while assets that are less liquid would not. Also, the more liquid the collateral, the greater the effect we would expect on the IBR.

Can we ignore the adjustments for collateralized borrowing if they aren't material?

Some companies may not plan to use collateralized IBRs, on the basis of materiality (i.e., the effect of incorporating collateral will not have a material impact on their financial statements). In particular, some companies have asserted their credit rating is so strong that securing a loan with collateral would not have a meaningful impact on the borrowing rate. Others have made formal inquiries to their lenders about the impact of collateral and have concluded that the difference between a collateralized and non-collateralized borrowing rate would not be material. However, given the new standard's explicit requirement to use a collateralized rate—and the fact that materiality is company-specific—we suggest all companies contemplating the use of uncollateralized IBRs discuss the issue with their auditors.

Should we assume over- or under-collateralization if facts and circumstances suggest that a lender would require it for a similar borrowing?

Based on discussions with FASB and SEC staff, it appears companies should generally assume full (not over- or under-) collateralization and that they are not expected or required to establish levels of collateralization that would typically be required by lenders in similar circumstances (i.e., collateralization based on traditional loan-to-value requirements for loans related to different asset types).

Can we obtain an IBR from our bank or other lender?

It depends.

If the banker or other lender is willing to provide an entity-specific discount rate that considers each of the following factors in the definition of IBR, then that discount rate may be reasonable: (1) the entity's risk profile, (2) lease term, (3) total lease payments, (4) jurisdiction where the lease is being executed, and (5) factoring in the collateral in an amount equal to the amount of lease payments.

If, in contrast, the lender is not willing to provide an entity-specific discount rate based on the aforementioned assumptions, then that discount rate may not be reasonable. This would generally be the case when:

- The rate is a secured lending rate that assumes some level of borrower's equity (i.e., collateral), which makes it difficult to understand whether the collateral is as liquid as the leased asset or indicative of being fully collateralized (not under- or over-collateralized)
- The rate does not consider the lease term; or
- The rate may not be for an amount that is equal to the lease payments.

Getting started

Estimating the discount rates for leases might seem like a minor technical issue. However, given the large potential impact on your company's balance sheet, it is worth investing the time and effort in its determination.

A robust and auditable approach will likely reflect a wide variety of data points, ranging from general economic conditions and interest rate trends to company- and lease-specific factors such as credit rating, parent/subsidiary structure, collateralization, and lease type/terms. However, this is a dynamic and evolving area involving significant judgment, so companies should consider discussing any questions and concerns with their auditors and other professional services providers to help determine what assumptions and approaches are likely to be acceptable.

Let's talk:

For additional information regarding the above and other interpretative guidance related to the lease standard, contact:

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