MEASURING A LEASE:
How to Determine Incremental Borrowing Rate

Exploring ASC 842, Leases

ASC 842 requires lessees to record all lease liabilities on the balance sheet based on the present value of the future lease payments. Determining the present value of future lease payments will require determining an appropriate discount rate for each of the entity's leases, which requires giving consideration to the contractual terms and jurisdictions of each individual lease resulting in potentially different rates for different leases. The discount rate is also used in determining the lease classification.

Lessees have options when it comes to which method they use to determine their discount rate. It is important to understand what the options are, how they differ, and the relative advantages or disadvantages of each in order to ensure the best method has been selected to address the lease arrangements.

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Background

Over the course of a lease, the value of the lease payments will change due to fewer remaining payments and other factors. To estimate the present value of the future lease payments, entities will need to determine an appropriate discount rate.

While lessors always use the rate implicit in the lease, lessees have three options for the lease discount rate:

1. Rate implicit in the lease, if readily determinable;
2. Risk-free rate (private companies only); or
3. Lessee's incremental borrowing rate.

Some situations may limit the lease discount method used. For example, the rate implicit in the lease might not be reasonably estimable except for possibly in related party or common control situations. The rate implicit in the lease is the rate of interest, at a given date, that causes the aggregate present value of (i) the lease payments and (ii) the amount that a lessor expects to derive from the underlying asset following the end of the lease term (i.e., the expected residual value) to equal the sum of (a) the fair value of the underlying asset minus any related investment tax credit retained and expected to be realized by the lessor and (b) any deferred initial direct costs of the lessor. Many of the components that go into rate implicit in the lease are lessor-specific and generally not expected to be knowable to the lessee. It would be inappropriate for the lessee to use its own assumptions or estimates for the lessor's expected residual value and initial direct costs to determine the rate implicit in the lease if those are deemed material inputs to the rate implicit in the lease.

There is another option for private entities, which is to use a risk-free discount rate. Private companies can make an accounting policy election by class of underlying asset to use a risk-free discount rate that corresponds to the term of the underlying lease, giving companies considerable flexibility. But keep in mind that the rate implicit in the lease must always be utilized if known to the lessee as may be the case in leases among related parties.

The advantage of using the risk-free rate is that it is simple to use and the data is readily available. Nevertheless, even if a lessee qualifies for the risk-free rate, it may not want to use it. The risk-free rate method results in a comparatively larger liability than the other two methods. In rare cases, the present value could equal or exceed substantially all the fair value of the leased asset, resulting in the classification of the lease as a finance lease instead of any operating lease. With finance leases, entities will generally recognize expense sooner than with operating leases. Use of a risk-free rate could also make it more difficult to execute an initial public offering.

Incremental Borrowing Rate

In the third option for determining the lease discount rate, lessees calculate their incremental borrowing rate (IBR). ASC 842 defines IBR as the rate of interest that the lessee would have to pay to borrow, on a collateralized basis over a similar term in a similar economic environment, an amount equal to the lease payments. The IBR should not represent a rate that is under- or over-collateralized. This means that lessees do not consider financing terms such as loan-to-value ratios by asset type. However, the collateral does not have to be the leased asset. It may be any asset that a creditor would accept to secure the borrowing as long as it is at least as liquid as the leased asset. It is not appropriate to use the interest rate from an entity's unsecured line of credit even if it would provide the funding to purchase the assets in lieu of leasing, which represents a change from the historical GAAP definition. The requirement to use a collateralized rate should result in a rate that is lower than an unsecured rate.

Potential data points for determining the IBR include the following:

- Existing debt
- Lender quotes
- Estimating IBR

The downside to using existing debt is that it is unlikely to match the terms of all the leases, and it is unlikely to reflect a similar economic environment. Lender quotes are good for situations where lessees have a good relationship with a lender. Both are generally inputs or a starting point to the IBR estimate.

Depending on the circumstances, lessees may have no choice but to use the third option, which requires judgment and possibly some additional valuation work.

Estimating the IBR

To estimate the IBR, lessees take a mosaic approach, combining different data points to get a full picture. Existing debt – its term, level of collateral, and date of issuance or market trades – will be one input. Lessees will also want to look at recent financing proposals for their terms and collateral.

Credit ratings, from a third party or a synthetic source, are another potential input. A credit rating reflects a rating agency's opinion of the entity's capacity and willingness to meet its financial commitments when due. Credit ratings can be given for the entire entity or issuer (sometimes referred to as a "family rating") or for a specific debt issuance. Corporate ratings represent a senior, unsecured rating. As a refresher, there are three main rating agencies – Fitch, Moody's, and Standard & Poor's (S&P). Investment grade ratings, representing the very lowest level of credit risk through moderate credit risk are Baa3/BBB- or above. Non-investment grade ratings, representing substantial credit risk and referred to as high-yield, speculative or junk, are Ba1/BB+ or below.

In instances where credit ratings are not available, valuation advisors can help estimate a synthetic credit rating using various types of regression analyses, academic models, or factors used in credit rating agency models.

Taken together, the data points help frame a rate and build an entity's collateralized yield curve. A yield curve is a line that plots interest rates (or "yields") for a debt instrument as a function of the remaining years to maturity.

The complexity of the IBR estimation depends on the entity's circumstances.

ESTIMATING IBR USING EXISTING COLLATERALIZED DEBT

For entities with collateralized debt, the entity "fits" its company's debt to a relevant corporate yield curve as of the origination date, which is available from third parties. A fit, in this case, will be a curve that comes as close as possible to the yield on the collateralized debt. The entity calculates the spread between the existing debt and the identified yield curve, and then applies that spread to the market yield curve as of the adoption date of Topic 842 or the subsequent commencement date of a new lease.

If the existing collateralized debt was not recently issued, the lessee would need to consider and adjust for any intervening events or circumstances so that the IBR appropriately reflects the entity's current credit environment. If the existing debt is unsecured, the lessee will need to adjust the IBR to reflect the impact of the collateral, which will result in a lower rate. In all these scenarios, the lessee should also consider the existing debt's original issuance discount and debt issuance costs, which affect the yield on the debt. These same considerations will also be required if the lessee utilizes a borrowing rate of similar entities with similar credit ratings and debt issued in the public debt markets with similar terms and seniority.

ESTIMATING IBR USING A WRITTEN LENDER QUOTE

The lessee may request a written quote from one or more of its banking and creditor relationships. In this scenario, it will be important for the lessee to ensure that the quote reflects the terms that are consistent with the lease terms and payment amounts, as well as is reasonably consistent with current market rates. Quotes from multiple lenders will help the lessee develop a sufficient basis that the estimated IBR is one that represents a rate that the creditors would actually lend.

ESTIMATING IBR USING LESSEE CREDIT RATING

Entities with a "family rating" or unsecured debt rating follow a similar process as the one described previously. The entity's unsecured credit rating is used to identify a relevant corporate yield curve. However, the credit rating is "notched up" a rating (or two) to approximate a secured yield curve.

ESTIMATING IBR USING A SYNTHETIC CREDIT RATING

Some entities may not have debt or rated debt. These entities may be able to estimate a synthetic or hypothetical credit rating, which is used to identify an appropriate secured yield curve following the methods described previously. An entity may also be able to estimate its credit rating by comparing its financial ratios and metrics to peer companies with publicly traded debt and published credit ratings.

BEST PRACTICES FOR ESTIMATED IBRS

Lessees with a high volume of lease activity may find it useful to develop a process for regularly updating their yield curves on a quarterly basis, for example, so that rates are ready to be used for new or modified leases. This process should include a documented review to ensure that the approach would not differ materially from calculating the IBR for each individual lease. The entity's process should also include an assessment of its own credit stability, as well as the stability of the lending markets. Regardless of the entity's policy, IBR should always be updated if significant events or circumstances have occurred that would indicate that the most recently updated IBR is no longer valid.

Other Matters

SUBSIDIARY USE OF PARENT IBR

Subsidiaries may not automatically use the parent company IBR as that rate reflects the credit rating of the parent. However, it may be appropriate to use the parent's IBR in those situations where the parent negotiates the lease and guarantees the lease payments. This is generally the case in consolidated groups with a centralized treasury function. Even when utilizing the parent IBR, the subsidiary would still consider the impact of the economic environment, jurisdiction, and currency, and adjust the parent IBR accordingly. Otherwise, the subsidiary will need to estimate a standalone IBR.

FOREIGN LEASES

For leases executed in a foreign country that are denominated in the foreign currency, lessees should use an IBR that reflects the interest rate that it could borrow funds in that foreign currency and jurisdiction taking into consideration the particular foreign economic environment.

LESSEE UNABLE TO OBTAIN FINANCING

The IBR may not be determinable for lessees who are unable to obtain third-party financing due to the entity's credit worthiness. In these situations, the lessee should look to the interest rates available in the marketplace for entities with the lowest credit rating.

PORTFOLIO APPROACH

The FASB acknowledges that a portfolio approach may be used by a lessee when "the entity reasonably expects that the application of the leases model to the portfolio would not differ materially from the application of the leases model to the individual leases in that portfolio." As a result, a lessee may be able to establish portfolios based on similar lease terms and underlying collateral, as well as the lessee's stable credit rating and interest rate environment.

TRANSITION

At the adoption date, lessees use an IBR as of the transition date and not as of the lease inception date. This leads to the question as to whether the transition date IBR should be based on the original or remaining term of the lease. ASC 842 does not provide any answers. Therefore, lessees will need to apply a consistent approach to all leases in existence at the adoption date

Takeaways & Final Thoughts

- The IBR must be based on a fully collateralized rate.
- The IBR must reflect a similar term and economic environment as the lease.

  Similar term is taken to mean both how the loan amortizes (payment terms) and the length of the lease. It is not appropriate to use the rate from an existing loan or debt facility or even a weighted-average of the entity's existing outstanding debt.
- The IBR is estimated as of a point-in-time.

  A point in time could be the lease commencement, modification, or reassessment date, which may result in an estimate that does not appear to be consistent with the IBRs from prior periods. It would be inappropriate to normalize the IBR when the lease commencement date, for example, occurs during a period of economic instability, such as what was experienced during 2020 as a result of COVID-19.

- Unless a portfolio approach is used, the unit of account under ASC 842 is the individual lease.

  Therefore, an IBR is estimated for each individual lease. It is not appropriate to estimate an entity-wide IBR.

- At transition, lessees with a significant number of leases may need to develop a curve of IBR to apply to the existing range of lease terms as of the adoption date.

  A similar approach may be applied in subsequent periods by those lessees with significant ongoing activity.

- Lessees must support that their IBR estimate is reasonable.

  Finally, because the IBR estimate may have a significant impact on the entity's recorded right-of-use asset and lease liability, the entity must support that its IBR estimate is reasonable. To the extent that the lease payments have a significant impact on the capital structure of the lessee, an entity should consider the increased credit-risk profile to this increase in debt obligations. The estimation process is not straightforward and may require robust documentation. A materiality analysis or sensitivity assessment alone may not be sufficient documentation. Thus, entities should plan accordingly.

For More Information...

For comments, questions or concerns about accounting for IBR, please contact a member of our team.

MHM (Mayer Hoffman McCann P.C.) is an independent CPA firm that provides audit, review and other attest services, and works closely with CBIZ, a business consulting, tax and financial services provider. CBIZ and MHM are members of Kreston Global, a worldwide network of independent accounting firms.