LEASES: ISSUES DETERMINING THE INCREMENTAL BORROWING RATE

18 March 2020

BDO

TODAY'S PRESENTERS

Aletta Boshoff
IFRS Advisory Partner
Melbourne

Kevin Frohbus
IFRS Advisory Partner
Sydney

Martin Emilson
Corporate Finance
Melbourne

David McCourt
Corporate Finance Partner
Sydney

OVERVIEW OF THIS WEBINAR

Background

Timing of the Determination of the Discount Rate

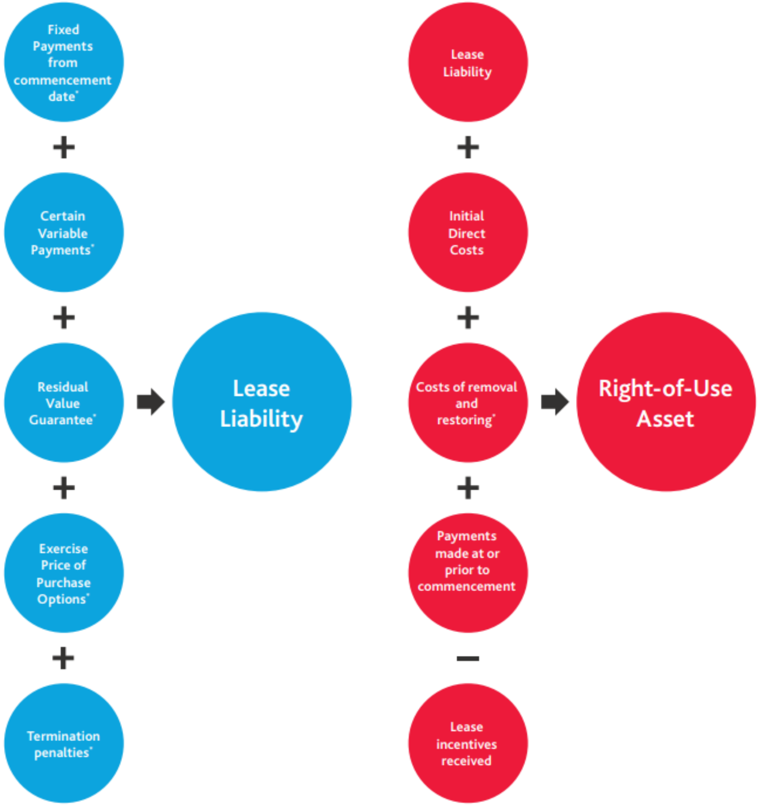
Practical Issues

Unit of Account

Developing an Estimate of the IBR

BACKGROUND

INITIAL MEASUREMENT OF THE LEASE LIABILITY



APPROPRIATE DISCOUNT RATE

- Objective of the IASB is to specify a discount rate that reflects how the contract is priced

- IFRS 16 paragraph 26
  - At the commencement date, a lessee shall measure the lease liability at the present value of the lease payments that are not paid at that date
  - The lease payments shall be discounted using the interest rate implicit in the lease, if that rate can be readily determined
  - If that rate cannot be readily determined, the lessee shall use the lessee's incremental borrowing rate

APPROPRIATE DISCOUNT RATE

Can the interest rate implicit in the lease be readily determined?

Yes

Use the interest rate implicit in the lease

No

Use the lessee's incremental borrowing rate

INTEREST RATE IMPLICIT IN THE LEASE

- The rate of interest that causes
- The present value of
  - the lease payments and
  - the unguaranteed residual value
- To equal the sum of
  - the fair value of the underlying asset and
  - any initial direct costs of the lessor

That portion of the residual value of the underlying asset, the realisation of which by a lessor is not assured OR is guaranteed solely by a party related to the lessor

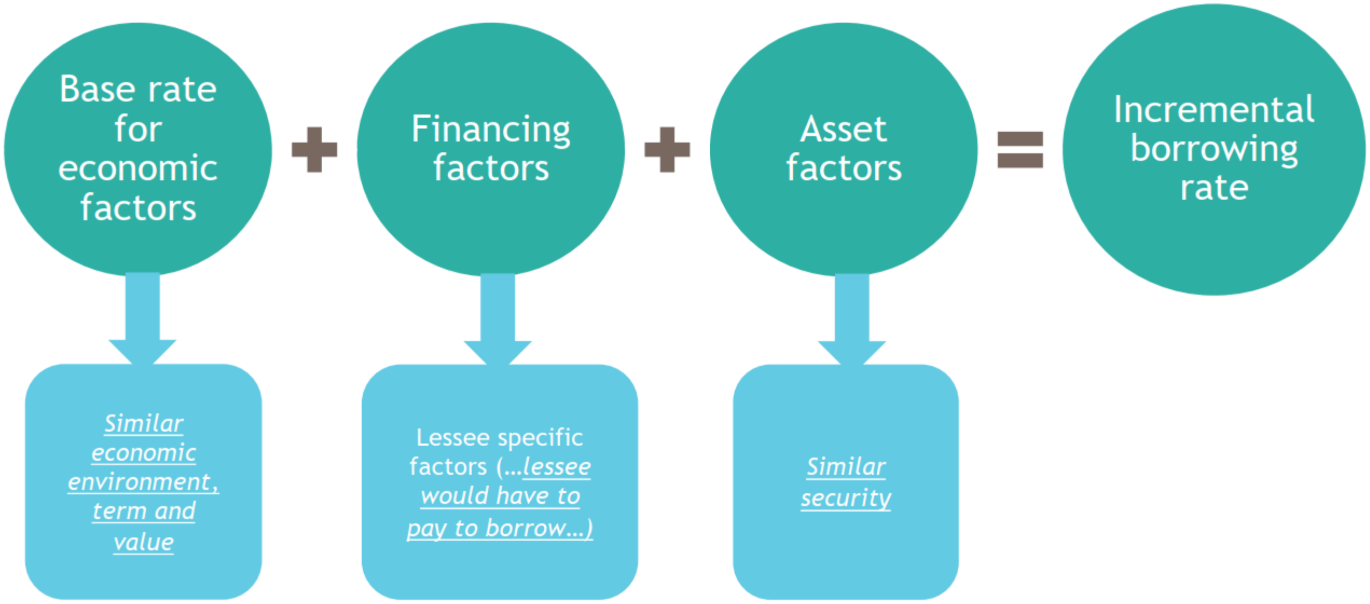
READILY DETERMINABLE…?

- Using the implicit rate presents the true financing cost of leasing an asset as opposed to paying for it up-front or buying it outright without financing
- Allowing the incremental borrowing rate to be used acknowledges that a lessee is often not able to determine the implicit rate
- A lessor often does not disclose the rate in the contract, or may offer a rate as being promotional (i.e. a below market interest rate), but also charge above-market lease rates to compensate for the low interest rate)
- Ultimately, to calculate the rate implicit in the lease requires:
  - Information about the fair value of the leased asset at the start of the lease
  - The ‘unguaranteed residual value’ (the fair value at the end of the lease if the residual value is not being guaranteed). However, in many leases it will not be possible to make a reliable estimate of this, particularly where the lease term is less than the leased asset’s useful economic life
- Does the lessee know what the initial direct costs of the lessor are?

LESSEE'S INCREMENTAL BORROWING RATE

- 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

LESSEE'S INCREMENTAL BORROWING RATE



LESSEE'S INCREMENTAL BORROWING RATE

- The IBR is not the interest rate that an entity pays on other debts (e.g. bank loans, revolving credit facilities, etc.)
  - These rates may be an input into measuring the IBR for a lease, or may be appropriate solely on the basis of materiality
  - However, they would not typically have a similar term, security and other economics characteristics as the underlying lease
- A discount rate is not determined for an entity as a whole, but for each individual lease
- Estimating the IBR may be difficult, as it will often be an estimate with several inputs required to arrive at an appropriate IBR
- An entity's WACC is not appropriate to use as a proxy for the IBR because it is not representative of the rate an entity would pay on borrowings
  - WACC incorporates the cost of equity-based capital, which is unsecured and ranks behind other creditors and will therefore be a higher rate than that paid on borrowings
  - The use of WACC would therefore result in the carrying amounts of both lease liabilities and right-of-use assets being understated

TIMING OF THE DETERMINATION OF THE DISCOUNT RATE

NEW LEASES (INITIAL RECOGNITION)

- The timing of the determination of the discount rate may affect lease measurement if there is a delay between contract inception and the commencement of the lease
  - This can arise in situations where significant events occur between the inception and commencement dates, which would affect either the lessee's incremental borrowing rate or the rate implicit in the lease
  - For example, credit deterioration of the lessee would affect the IBR and significant geopolitical or technological events could affect the fair value of the underlying asset, which would in turn impact the rate implicit in the lease
- In our view, the determination of the discount rate from the lessee's perspective is at the commencement date of the lease, as IFRS 16.23 requires a lessee to measure the right-of-use asset at the commencement date
  - The applicable discount rate is a component of the measurement of the lease, therefore, it is determined at the same time as other components of the measurement of the lease

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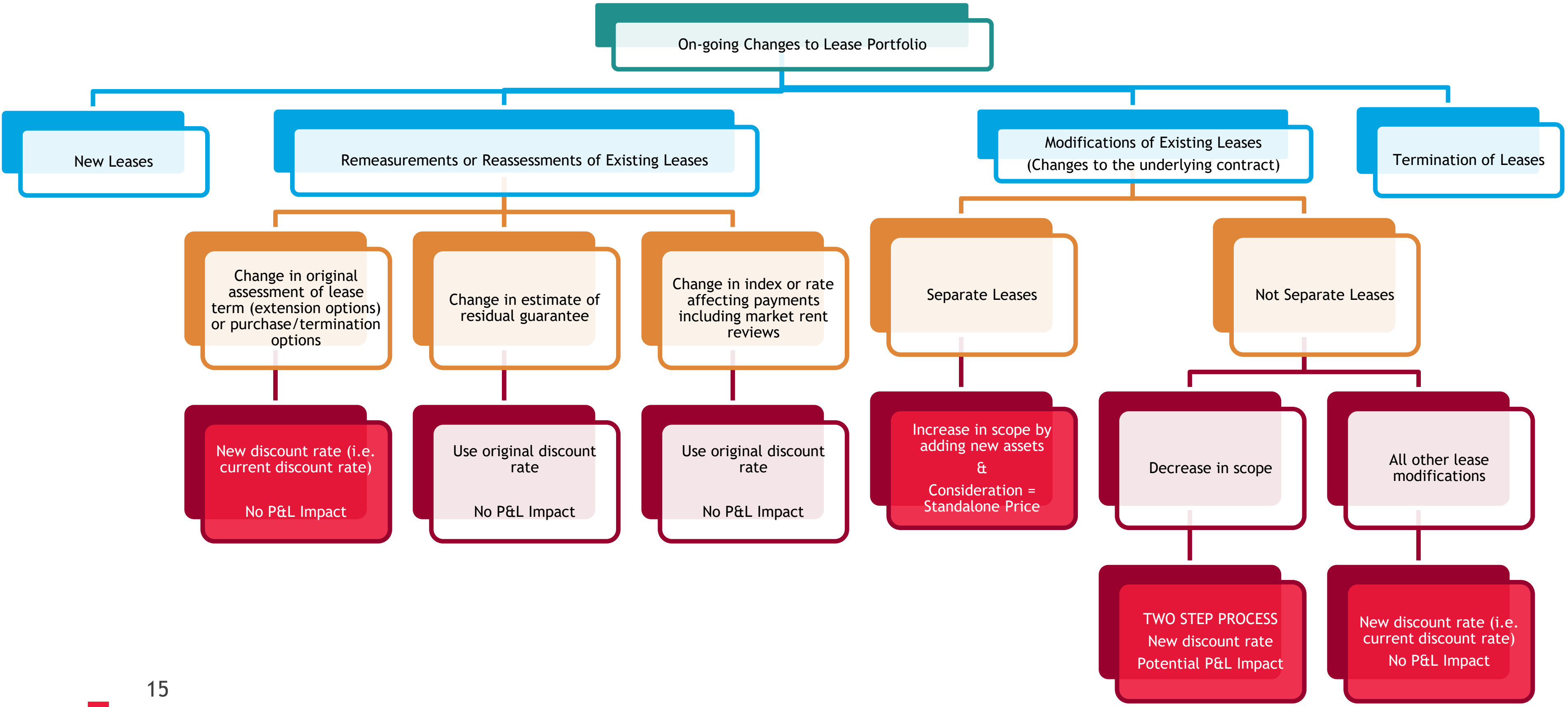
ON-GOING CHANGES TO LEASE PORTFOLIO



TRANSITIONING TO IFRS 16

- Retrospective Application Options for Lessees
  - Full Retrospective Method
  - Modified Retrospective Method
    - Modified Retrospective Method #1
      - RoU Asset = Lease Liability - Accrual/Prepayment ito old AASB 117
    - Modified Retrospective Method #2
      - RoU Asset is calculated on a retrospective basis & practical expedients available in its calculation AND the prevailing incremental borrowing rate at the date of initial application is used

TRANSITIONING TO IFRS 16

- For leases previously classified as operating leases under IAS 17, on transition to IFRS 16 using the modified retrospective approach,
  - The lease liability is initially measured at an amount equal to the remaining lease payments, discounted using the IBR at the date of transition (i.e. 1 January 2019 for calendar year-ends)
  - This means that to determine the IBR for an entity transitioning to IFRS 16, the 'lease term' is based on the remaining lease payments as at that date
  - For example, if a lease commenced on 1 January 2014 with a 10-year lease term, the lease would cease on 31 December 2023. Therefore, as at the date of transition to IFRS 16 (1 January 2019), the lease term is only the remaining period, which is 5 years. This would be the term used to estimate the IBR

TRANSITIONING TO IFRS 16

- The modified retrospective approach also permits (but does not require) a practical expedient that is available on a lease-by-lease basis, which affect the IBR
  - A lessee may apply a single discount rate to a portfolio of leases with reasonably similar characteristics (such as leases with similar remaining lease term for a similar class of underlying assets in a similar economic environment)
- This expedient is similar to the ongoing expedient available at all times, which permits the application of IFRS 16's requirements on a portfolio basis, however, the expedient available on transition does not establish a requirement to demonstrate that its application would not result in a materially different measurement

UNIT OF ACCOUNT

UNIT OF ACCOUNT

- The level at which IFRS 16 applies to leases (i.e. the unit of account) is the individual lease, therefore, a discount rate is not determined for an entity as a whole, but for each individual lease
- As a practical expedient, IFRS 16.B1 allows an entity to apply IFRS 16 to portfolios of leases with similar characteristics if the entity reasonably expects that the effects on the financial statements of applying this portfolio approach would not differ materially from applying IFRS 16 to the individual leases within that portfolio
- Before an entity attempts to determine its IBR for a contract or a portfolio of lease contracts, entities (and engagement teams) must first satisfy themselves that the portfolios that have been established satisfy the criteria in IFRS 16.B1

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UNIT OF ACCOUNT – EXAMPLE 1

- Two portfolios
  - Portfolio A consisting of real estate leases with lease terms of 3-5 years
  - Portfolio B consisting of real estate leases with lease terms of 7-10 years

- Appears to be consistent with the requirements of IFRS 16 since it considers similar underlying assets and terms; subject to economic environment
- For all portfolio application, must apply assumptions and estimates that reflect the size and composition of the portfolio (IFRS 16.B1); must not differ materially from apply IFRS 16 to individual leases

UNIT OF ACCOUNT – EXAMPLE 2

- One portfolio consisting of long-term real estate, equipment, automobile and land leases, with lease terms ranging from 2-25 years with lease payments totalling many times materiality

- Inappropriate because the lease term range is extremely broad (2-25 years), therefore, the portfolio does not consider 'similar term'

UNIT OF ACCOUNT – EXAMPLE 3

- Three portfolios for a global conglomerate entity with leases entered into by its subsidiaries, segmented by class of underlying asset and lease term, with the IBR determined for the group as a whole and applied to all subsidiaries in all geographic locations, including their individual IFRS-compliant financial statements

- Inappropriate, does not consider a similar economic environment as leases in 5 different jurisdictions have been grouped together and the lease term range is also very broad (10-40 years)

UNIT OF ACCOUNT – EXAMPLE 4

- Two portfolios for a global conglomerate entity with leases entered into by its subsidiaries, with the IBR determined at the group level, then adjusted for lease term:
  - Portfolio A consisting of real estate leases in Country Z with lease terms of 3-5 years
  - Portfolio B consisting of real estate leases in Country X with lease terms of 7-10 years

- Inappropriate, does not consider the fact that the leases were entered into by the subsidiaries in the group structure in different geographic locations (i.e. the IBR is not 'the rate of interest that a lessee would have to pay'). The use of an IBR which reflects the interest rate that the corporate parent would pay would generally not be appropriate, although it is necessary to consider the overall structuring of the arrangements

DEVELOPING AN ESTIMATE OF THE IBR

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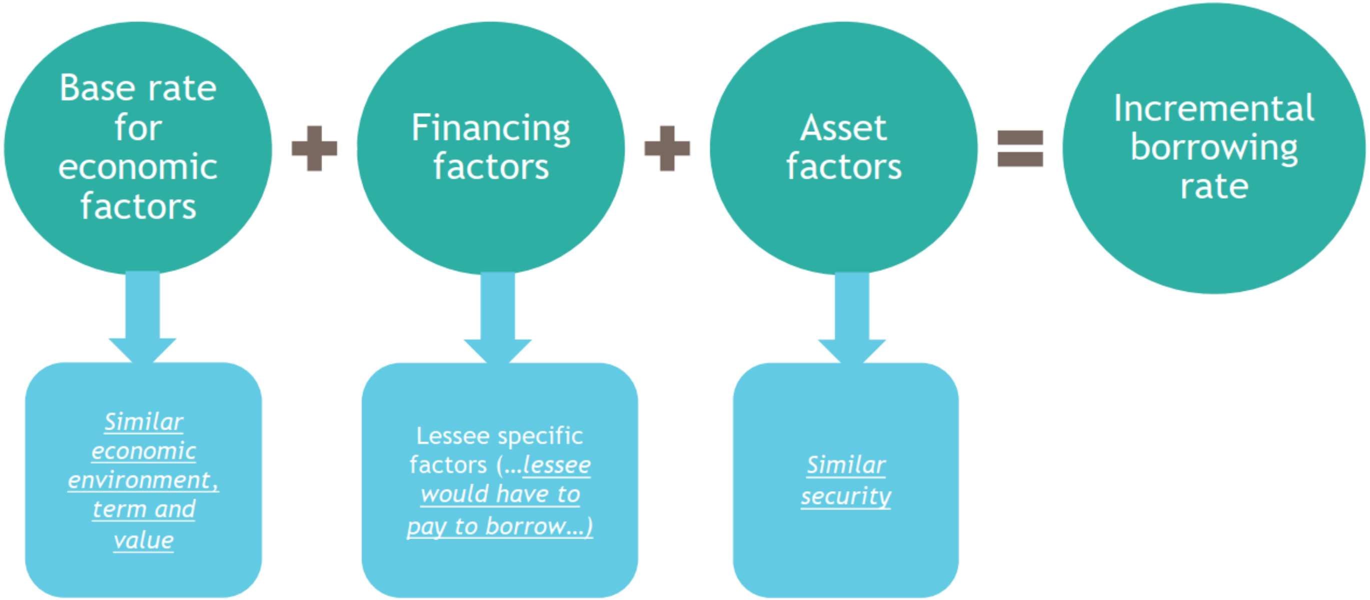
- A common approach is to determine a ‘base rate’ (or ‘reference rate’) based on readily observable interest rates for public or liquid corporate debt and adjust that rate for relevant factors



BASE RATE

Description	Practical Considerations
May be a 'risk-free' or low risk interest rate that considers similar term, amount borrowed, jurisdiction and currency of repayment	Base rates may be obtained for government debt instruments or other readily observable information In some jurisdictions, commercial debt with a similar credit quality to the lessee may exist, reducing the need to adjust the base rate for credit characteristics that differ from the base rate

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CREDIT RISK

Description	Practical Considerations
The IBR is meant to reflect the rate a lessee would have to pay to borrow; therefore, it considers the credit risk of the borrower The characteristics of the agreement between the lessee and the lessor will affect adjustments required for credit risk. Generally, the credit quality of the legal entity entering into the lease should be used to estimate the effect of credit risk on the IBR	If a base rate has been used that considers similar economic characteristics such as term, currency, etc., then a 'credit spread' may be added to the base rate Credit spreads may be observable by analysing the interest rates on publicly observable debt with a similar credit characteristic to the entity

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SECURITY

Description	Practical Considerations
Many base rates will be unsecured loans (e.g. government bonds), which is not consistent with most leases As a lease is essentially a borrowing secured by the underlying right-of-use asset, a security factor may be considered to reduce the IBR	Depending on the nature of the underlying asset, the adjustment to the IBR for security may vary For leases secured by assets with long-term useful lives that the lessor can repossess and lease to another third party with relative ease or sell for a significant amount (e.g. office space), the adjustment to the base rate may be relatively significant due to the nature of the security

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Many base rates will be unsecured loans (e.g. government bonds), which is not consistent with most leases As a lease is essentially a borrowing secured by the underlying right-of-use asset, a security factor may be considered to reduce the IBR	For leases secured by assets with short-term useful lives or are difficult to repossess and lease to another third party or sell for more than a relatively insignificant amount (e.g. laptop computers, some equipment), the adjustment to the base rate may be insignificant due to the nature of the security

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SECURITY

Description	Practical Considerations
Many base rates will be unsecured loans (e.g. government bonds), which is not consistent with most leases As a lease is essentially a borrowing secured by the underlying right-of-use asset, a security factor may be considered to reduce the IBR	Estimates of adjustments to account for security may be estimated by observing interest rate spreads between secured and unsecured borrowing for entities in similar economic environments with similar credit risks For entities with very high (investment grade) credit ratings, the IBR may not be affected, or may be affected to only a very small extent, depending on whether borrowings are secured

PRACTICAL ISSUES

WHAT IF AN ENTITY HAS NO BORROWINGS?

- For example, a start-up entity in the biomedical industry might be financed entirely by the issuance of equity instruments
- It would not necessarily have any readily observable borrowing rates on any debt, due to it having a very high risk of default on any loans, making it unattractive for traditional lending
- However, the entity may have leases, such as office space, which require an IBR to be estimated
- In such cases, the IBR may be close to the entity’s equity cost of capital, since the nature of a loan (including a lease) to an entity with extremely high credit risk is, in practical terms, close to that of an equity investment
- Cases such as these would generally be rare and careful consideration would be required to determine that a rate similar to the equity cost of capital is appropriate

SUBSIDIARY INCREMENTAL BORROWING RATE

Background

- A subsidiary is part of a group where all funding and treasury functions are handled centrally by the parent
- The parent grants loans to subsidiaries (which do not borrow from third party lenders) and also guarantees payments under leases that subsidiaries have entered into
- The subsidiary has entered into a lease agreement as the lessee
- The interest rate implicit in the lease is not readily determinable
- The parent provides a guarantee of the subsidiary lease payments

Issue

Can the subsidiary use the parent’s incremental borrowing rate (IBR)?

BULLET LOANS VS AMORTISING LOANS

Background

- A lessee enters into a 10-year lease with equal monthly payments. The weighted average life of the lease is 5.5 years
- The lessee cannot readily observe a borrowing rate for a similar amortising loan, but they can observe borrowing rates for bullet loans with a 5-year maturity and 10-year maturity
- Part of the definition of the lessee's incremental borrowing rate is '*borrow over a similar term*'

Issue

Is the IBR the borrowing rates for bullet loans with a 5-year maturity and 10-year maturity?

NOMINAL OR REAL DISCOUNT RATES

Background

- Lessee enters into a 10 year lease contract that has variable lease payments dependent on an index or rate
- The payments are adjusted on an annual basis to reflect the accumulated inflation of the past twelve months
- For example, a lessee may enter into a ten year lease contract where the lease payments are adjusted annually for changes in inflation. This results in the lease having variable payments that are dependent on an index or rate
- Applying the requirements of IFRS 16.27(b), the lessee initially measures the lease using payments in the lease contract based on the current inflation rate (i.e. the lessee does not estimate future changes in inflation)
- The lessee cannot readily determine the interest rate implicit in the lease; therefore, it uses an estimate of the lessee’s incremental rate of borrowing (IFRS 16.26)

Issue

In measuring the lease liability using the lessee’s incremental rate of borrowing, should a nominal or a real rate be used? Note that a nominal discount rate does not consider inflation, whereas a real discount rate does. A real discount rate aims to remove the effects of inflation to reflect the real cost of debt to the borrower

DO YOU NEED ASSISTANCE?

RELEVANT ARTICLE PUBLISHED ON CA ANZ WEBSITE

- https://www.charteredaccountantsanz.com/news-and-analysis/news/valuing-using-risk-free-rate-based-on-cash-flow-duration-now-more-relevant

DATE POSTED: 2/03/2020 | 7 MIN READ

Valuing using risk-free rate based on cash-flow duration now more relevant

BDO Australia's Martin Emilson discusses selecting the appropriate risk-free rate based on cash-flow duration.

IN BRIEF

- In valuation theory, the risk-free security should generally match the cash-flow period
- But there are times when this may not be the best approach
- This is particularly relevant in light of the new lease standards (IFRS 16)

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FREE RESOURCES

- Monthly Webinars
  - https://www.bdo.com.au/en-au/insights/audit-assurance/webinars/2019-bdo-financial-reporting-and-accounting-standards-webinar-series
- Interactive E-learning
  - https://www.bdo.com.au/en-au/services/audit-assurance/ifrs-advisory-services/accounting-standards-training
- Monthly Accounting News
  - https://www.bdo.com.au/en-au/accounting-news/accounting-news-december-2019
- IFRS Publications
  - https://www.bdo.com.au/en-au/services/audit-assurance/ifrs-advisory-services/ifrs-publications

AN EXPERIENCED TEAM

Our Specialist Team is Highly Qualified and Experienced in All Aspects of Corporate Finance....

Stephen Seear
PARTNER
stephen.seear@bdo.com.au
+61 3 9603 1862

David McCourt
PARTNER
david.mccourt@bdo.com.au
+61 2 9240 9738

Adam Myers
PARTNER
adam.myers@bdo.com.au
+61 8 6382 4751

Chris Catanzaro
PARTNER
chris.catanzaro@bdo.com.au
+61 7 3237 5661

David Fechner
PARTNER
david.fechner@bdo.com.au
+61 8 7421 1413

IFRS ADVICE

Melbourne & National

Aletta Boshoff
PARTNER
aletta.boshoff@bdo.com.au
+61 3 9603 1808

Perth

Wayne Basford
PARTNER
wayne.basford@bdo.com.au
+61 8 6382 4715

Sydney

Kevin Frohbus
PARTNER
kevin.frohbus@bdo.com.au
+61 2 8264 6696

Perth

Susan Oldmeadow-Hall
PARTNER
susan.oldmeadow-hall@bdo.com.au
+61 8 6382 4670

Brisbane

Clark Jarrold
PARTNER
clark.jarrold@bdo.com.au
+61 7 3237 5654

BDO IFRS ADVISORY TEAM


Aletta Boshoff
Partner, National Leader


Wayne Basford
Partner


Clark Jarrold
Partner


Susan Oldmeadow-Hall
Partner


Kevin Frohbus
Partner


Dean Ardern
Associate Director


Sheryl Levine
Associate Director


Kay Kelly
Associate Director


Sunita Popp
Associate Director


Susan Healy
Associate Director


Ashleigh Woodley
Associate Director


Evelyn Hogg
Associate Director


Judith Leung
Associate Director


Julie Pagcu
Associate Director


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Associate Director


Linh Dao
Senior Manager


Christine Webb
Senior Manager


Anita Sljuka
Manager

SELECTION OF AN APPROPRIATE TECHNOLOGY SOLUTION - BDO LEAD

AASB 16 – FP & NFP

1 to 10 leases

10 to 200 leases

More than 200 leases

Excel

BDO Lease Management Services

BDO Lease Management Services

BDO Lead SaaS

BDO Lease Management Services

AASB 16 Masterclasses

DO YOU NEED ASSISTANCE FROM OUR IFRS EXPERTS?

BDO Lead Software-as-a-Service (BDO Lead SaaS)

- If you are looking for an easy-to-use IFRS 16 compliant technology solution to manage your lease portfolio, look no further than BDO Lead. BDO Lead gives you control over you lease data and the ability to process changes and prepare reports effectively and efficiently across all your leases
- BDO Lead has been developed by our IFRS experts and custom-built by our IT experts. BDO Lead is a cloud solution hosted on Microsoft Azure in Canberra
- The main benefits of using BDO Lead, are that you have control of your own data but also access to our very experienced IFRS experts to talk you through the relevant considerations when performing your lease calculations

BDO Lease Management Services

(Outsourcing of your lease accounting)

- Many entities are currently grappling with the implementation of IFRS 16, and also starting to contemplate ongoing management of their lease portfolio
- Our clients are telling us that they want the best possible lease accounting outcomes for their business, and they want the associated process to be easy and cost-effective. In short, our clients want the best lease accounting outcome without any hassle
- We have responded to these requests from our clients, by creating BDO Lease Management Services where our clients outsource their lease accounting problems to our experienced IFRS experts
- We know and understand the intricacies of IFRS 16, AND we have an amazing technology solution (BDO Lead) to perform all the required calculations

AASB 16 Masterclasses

- Our hands-on masterclass will have you ready to adopt AASB 16
- Run by BDO's IFRS Advisory experts, it will assist you in preparing the journals for adoption of AASB 16
- Through the use of a practical case study and Excel, attendees will leave the day with an in-depth knowledge of:
  - How to perform the initial calculation of the lease liability and the related interest expense efficiently
  - How to perform the initial calculation of the ROU asset and the related depreciation expenses efficiently
  - The ongoing reassessments required to the lease liability and ROU asset as a result of CPI increases, market reviews and changes to the lease term due to various options
  - The ongoing modification of the lease liability and the ROU asset

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BDO LEAD SAAS

- https://www.bdo.com.au/en-au/services/audit-assurance/ifrs-advisory-services/ifrs-16/ifrs-tool-bdo-lead

- https://youtu.be/XIfCevmbEhI

BDO LEASE MANAGEMENT SERVICES

- https://www.bdo.com.au/en-au/services/audit-assurance/ifrs-advisory-services/ifrs-16/lease-management-services
- https://youtu.be/mA1AxOz2kN8

AASB 16 MASTERCLASSES

- https://www.bdo.com.au/en-au/services/audit-assurance/ifrs-advisory-services/ifrs-16/aasb-16-masterclasses

QUESTIONS

DISCLAIMER