As public entities\(^1\) finalize implementation efforts for the newly effective lease guidance, it has quickly become apparent that one of the most challenging aspects of the new rules is the calculation of the appropriate discount rate. Under Accounting Standards Codification (ASC) 842, *Leases*, lessees will recognize substantially all leases on their balance sheets as lease liabilities with a corresponding right-of-use (ROU) asset. The discount rate used can materially affect the valuation of the lease liability and asset recognized. The higher the discount rate is, the lower the lease liability will be; the lower the discount rate is, the higher the lease liability will be. Determining the discount rate will be a significant area of judgment that will require supporting documentation and may necessitate new internal controls. FASB has provided substantial relief for private companies and not-for-profits (NFP), which many are likely to take advantage of. This paper is designed to help nonpublic entities weigh the costs and benefits of electing the relief offered.

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Do not underestimate the time required for this critical step in lease implementation.

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FASB recently approved additional time for private companies and NFPs to implement ASC 842. For help getting started, see BKD’s article “*Leases: The Countdown Begins for Private Companies & Not-for-Profit Organizations*.”

**Rate Implicit in the Lease**

The discount rate used by the lessee and lessor is the rate implicit in the lease at the lease commencement date, which is the internal rate of return on all lease payments. The implicit rate is the discount rate that exactly balances the lease payments and the fair value of the leased assets for the lease term at lease commencement or the required remeasurement date (see below).

For lessees, determining the rate implicit in the lease is challenging because that rate is a lessor-specific internal measure that is rarely disclosed. To determine the implicit rate, a lessee must know both the lessor’s estimate of the underlying asset’s residual value and the amount of initial direct cost the lessor will defer for the lease. The

\(^1\) A public entity is defined as any one of these:
- A public business entity
- An NFP entity that has issued—or is a conduit bond obligor for—securities traded, listed or quoted on an exchange or over-the-counter market
- An employee benefit plan that files or furnishes financial statements to the SEC
residual value is most easily determined if there is a provision to convey the asset to the lessee at the end of the lease term through a bargain purchase option or title transfer provision.

For a lessor to calculate an implicit interest rate, a market value is needed for the related property, space or land. For some asset types, equipment or office space in a downtown building, market data are not too difficult to obtain. For other specialized asset types, the market value will be more challenging. A valuation specialist might be needed to apply a cost, income or market approach—or some combination of these approaches—to arrive at a lease’s supportable implicit rate.

Subsequent amendments in Accounting Standards Update (ASU) 2018-10 clarified that the rate implicit in the lease can never be less than zero.

Consistent with current guidance, if the lease’s implicit interest rate is not readily determinable, the lessee’s estimated incremental borrowing rate (IBR) should be used. Determining the IBR entails estimating the interest rate the lessee would be charged for borrowing the lease payment amounts during the lease term.

Discount Rate Relief

Private Company & NFP Relief

Nonpublic entities are permitted to make an accounting policy election to use a risk-free rate for a comparable term when measuring their lease obligations; once elected, it must be used consistently for all leases. In addition, FASB is holding a roundtable meeting in April to determine if further relief is warranted for nonpublic companies. BKD will continue to follow these developments.

Remember, a lower discount rate will lead to a higher lease liability. The discount rate also affects the allocation of total expense between depreciation and interest expense—a higher discount rate will reduce depreciation and increase interest expense each period in the lease term.
Discount Rate Considerations for Private Company & NFP Leases

Portfolio Approach

Lessees and lessors can apply a single discount rate to a lease portfolio if the outcome is not materially different when compared to individually calculated discount rates applied to each lease in the portfolio. Lease portfolios may be based on asset type, term or geographic location. Quantitative support is not required by ASC 842; however, an entity should document how the leases in the portfolio have similar characteristics, such that it is reasonable to expect that the application of the portfolio approach is not materially different from individual calculations.

If this approach is elected, an entity will need to establish internal controls to determine and monitor the portfolio composition.

IBR

ASC 842 has an updated IBR definition. ASC 840 did not require the use of a secured rate. Under ASC 840, a lessee could use a weighted average rate that considered secured and unsecured funding if certain loan-to-value criteria were met. ASC 842 requires a lessee to use a secured rate. ASC 842 does not dictate the nature of the assets collateralizing the borrowing. A lessee could use other assets unrelated to the leased asset if the lessee has the right to pledge the asset as collateral. The collateral should be at least as liquid as the leased asset.

The lessee must assume its borrowing is fully collateralized—an adjustment would be needed for any over- or under-collateralized arrangements.

<table>
<thead>
<tr>
<th>IBR</th>
<th>ASC 840</th>
<th>ASC 842</th>
</tr>
</thead>
<tbody>
<tr>
<td>The rate the lessee would have incurred to borrow over a similar term the funds necessary to purchase the leased asset</td>
<td>The rate of interest 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</td>
<td></td>
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</tbody>
</table>

For a lease with fixed payments in which the lessee and lessor have similar credit ratings, the interest rate implicit in the lease will generally be higher than the lessee’s incremental borrowing rate.

Below is a basic framework to calculate the IBR, which reflects the lessee credit, lease term, the nature and quality of the collateral provided and the transaction’s economic environment. These components or inputs will vary from lease to lease, which could result in different IBRs for every lease or lease component.
Discount Rate Considerations for Private Company & NFP Leases

Base Rate

The first step is to establish an appropriate base rate, which will then be adjusted for credit-specific and lease-specific items. For some larger entities, the starting point may be based on debt already outstanding. For entities without outstanding debt or debt that is not publicly traded, a risk-free rate may be the only starting point.

Secured Rate

An entity can determine a base rate from its own publicly traded debt. If an entity does not have public debt, but has consummated a recent debt financing, this can be used as the starting benchmark. Alternatively, if the entity has recently been rated by a major rating agency, a base rate can be estimated by comparison to similarly rated entities with outstanding debt.

Risk-Free Rate

If no debt is outstanding, start with a risk-free rate that approximates the lease term. In general, the data are publicly available; however, there may be some circumstances when an exact match does not exist for the lease term or inception date. In such cases, judgment may be required to determine a suitable risk-free reference rate.

Financing Adjustments

An entity would need to adjust the base rate to reflect credit-specific factors such as the overall level of indebtedness or if the lease results in a change to leverage ratio, which would warrant a higher IBR. In some cases, it might be reasonable for a subsidiary to use a parent entity or group’s IBR as the discount rate. Depending on the lease terms and conditions and the corresponding negotiations, the parent entity’s IBR may be the most appropriate rate to use as a practical means of reflecting the contract’s interest rate, assuming the implicit rate is not readily determinable. This might be appropriate when the subsidiary does not have its own treasury function (all funding for the group is managed centrally by the parent entity) and, consequently, the lessor negotiations result in the parent entity guaranteeing the lease payments. Because the lease pricing is more significantly influenced by the parent’s credit standing than that of the subsidiary, the parent’s IBR is appropriate.

Lease-Specific Adjustments

The base rate also should be adjusted for the following lease-specific items:

- **Term** – In general, if the term is longer, the rate will be higher (since the risk is higher).
- **Timing of Payments** – If more payments are made upfront, the risk—and rate—may be lower. The rate also would need to be adjusted to reflect any prepayment options.
- **Collateral** – The nature of the collateral will influence the IBR. For example, the costs of repossessing a low-value asset, **e.g.**, a printer, would be high relative to the asset’s underlying value and associated lease cash flows, and collateral benefits would likely be relatively insignificant. Alternatively, for larger-value assets, **e.g.**, a car or property, the collateral benefit is more valuable because the lessor is more likely to obtain value in the event of default.

Updates to the Discount Rate

Under ASC 840, an entity could generally set key factors at lease inception and not have to reconsider those decisions over the lease term unless a contract was modified or an option was exercised. Under ASC 842, a lessee should remeasure the lease liability and adjust the ROU asset if any of the following occur:

- The lease is modified, and the modification is not accounted for as a new, separate contract.
- A contingency is resolved such that some or all variable payments become fixed. A change in a reference rate or index for variable lease payments does not constitute the resolution of a contingency.
Discount Rate Considerations for Private Company & NFP Leases

- There is a change in:
  - The lease term
  - The assessment of whether the lessee will exercise or not exercise a purchase option
  - The probable amount the lessee will owe under a residual value guarantee (RVG)

<table>
<thead>
<tr>
<th>Lease Modification &amp; Reassessment</th>
<th>Reallocate contract consideration and remeasure the lease</th>
<th>Reassess classification</th>
<th>Update discount rate</th>
</tr>
</thead>
<tbody>
<tr>
<td>Lease modification</td>
<td></td>
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<tr>
<td>An event occurs that gives the lessee a significant economic incentive to exercise/not exercise a renewal or termination option</td>
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<tr>
<td>An event occurs that gives the lessee a significant economic incentive to exercise/not exercise a purchase option</td>
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<tr>
<td>Variable payments become fixed</td>
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<tr>
<td>Amounts due under an RVG become probable of being owed</td>
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</tbody>
</table>

Disclosures

ASC 842 adds significant new disclosures. Lessees must now disclose significant judgments, including the determination of the lease’s discount rate. A new quantitative disclosure requires supplemental noncash information on lease liabilities arising from obtaining ROU assets, including the weighted-average remaining lease term and weighted-average discount rate.

Transition

<table>
<thead>
<tr>
<th>Transition Options</th>
<th>Modified Retrospective, As Issued</th>
<th>Modified Retrospective Option (ASU 2018-11)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Discount rate must be determined at the later of (1) the beginning of the earliest comparative period presented or (2) the lease commencement date</td>
<td>An incremental borrowing rate would be determined at date of adoption. ASC 842 is silent on whether the remaining or original lease term should be used; therefore, an entity can choose one or the other, but the choice must be used consistently for all leases</td>
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</tbody>
</table>
Discount Rate Considerations for Private Company & NFP Leases

Except for subleases, a lessor is not required to make any adjustments at transition. A lessee electing the original retrospective approach would require extensive historical information to determine the appropriate IBR or implicit lease rates. Because of this, most public companies have elected a modified retrospective transition in the year of adoption, which means a lessee measures the lease liability as the present value of the remaining payments using the lessee’s IBR at the adoption date.

Conclusion

For some entities, ASC 842’s adoption will be complex and likely will require significant hours to implement correctly. BKD can help educate your team, provide implementation tools and assist with analysis and documentation. If you would like assistance complying with the new guidance, contact your BKD Trusted Advisor™.

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Appendix

Example – Portfolio Approach

Lessee, a public entity, is the parent of several consolidated subsidiaries. During the current period, two subsidiaries entered into a total of 400 individual leases of large computer servers, each with terms ranging between four and five years and annual payments ranging between $60,000 and $100,000, depending on the servers’ hardware capacity. In aggregate, total lease payments for these leases amount to $30 million.

The individual lease contracts do not provide information about the rate implicit in the lease. Lessee is BBB credit rated and actively raises debt in the corporate bond market. Both subsidiaries are unrated and do not actively engage in treasury operations in their respective markets. Based on its credit rating and the collateral represented by the leased servers, Lessee’s incremental borrowing rate on $60,000 through $100,000 (the range of lease payments on each of the 400 leases) would be approximately 4 percent. Lessee notes that five-year, zero-coupon U.S. Treasury instruments are currently yielding 1.7 percent (a risk-free rate). Because Lessee conducts its treasury operations centrally, i.e., at the consolidated group level, it is reasonably assumed that consideration of the group credit standing factored into how each lease was priced.

Lessee may determine the discount rate for the lease for the 400 individual leases entered on different dates using a portfolio approach and use a single discount rate to the new lease portfolio. This is because during the period, the new leases have similar terms (four to five years), and Lessee’s credit rating and the interest rate environment are stable. Because the pricing of the lease is influenced by the credit standing and profile of Lessee rather than the subsidiaries, i.e., because Lessee conducts treasury operations for the consolidated group, Lessee concludes that its incremental borrowing rate of 4 percent is an appropriate discount rate for each of the 400 leases entered into by Lessee’s two subsidiaries during the period. Because Lessee is a public entity, it is not permitted to use a risk-free discount rate.