ASC 842: Discount Rate Considerations – Private Companies & NFPs

One of the many challenging aspects of Accounting Standards Codification (ASC) 842, Leases, is the calculation of the appropriate discount rate. The discount rate directly affects lease classification (operating or finance) and the measurement of a lessee's lease liability and corresponding right-of-use (ROU) asset. 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 nonprofits (NFP).

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

Effective Dates
ASC 842
(as amended)

Private Companies & NFPs
Annual periods beginning after
December 15, 2021

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, unless that rate cannot be readily determined. 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 inception or the required remeasurement date (see below).

Present Value of Lease Payments + Present Value of Unguaranteed Residual Value = Fair Value of the Underlying Asset + Lessor's Initial Direct Costs

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

The 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 a 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, such as 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.

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.

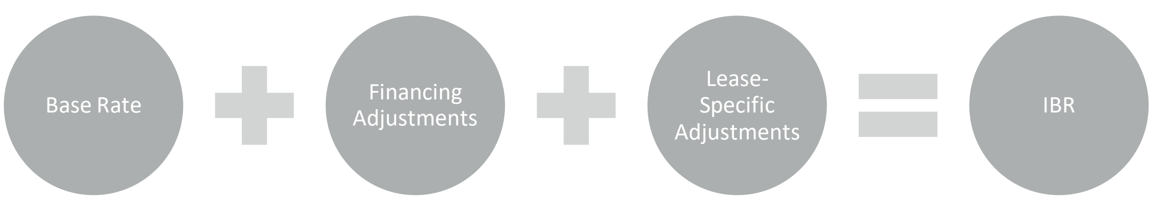
IBR

The IBR is the rate at which a lessee could borrow a similar amount from its lending institution. 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. This presents operational challenges as most companies borrow on an unsecured basis.

IBR	
ASC 840	ASC 842
The rate that the lessee would have *incurred to borrow* over a similar term the funds necessary to purchase the leased asset	The rate of interest that 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

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 IBR as the implicit rate includes the lessor's profit margin.

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.**



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:

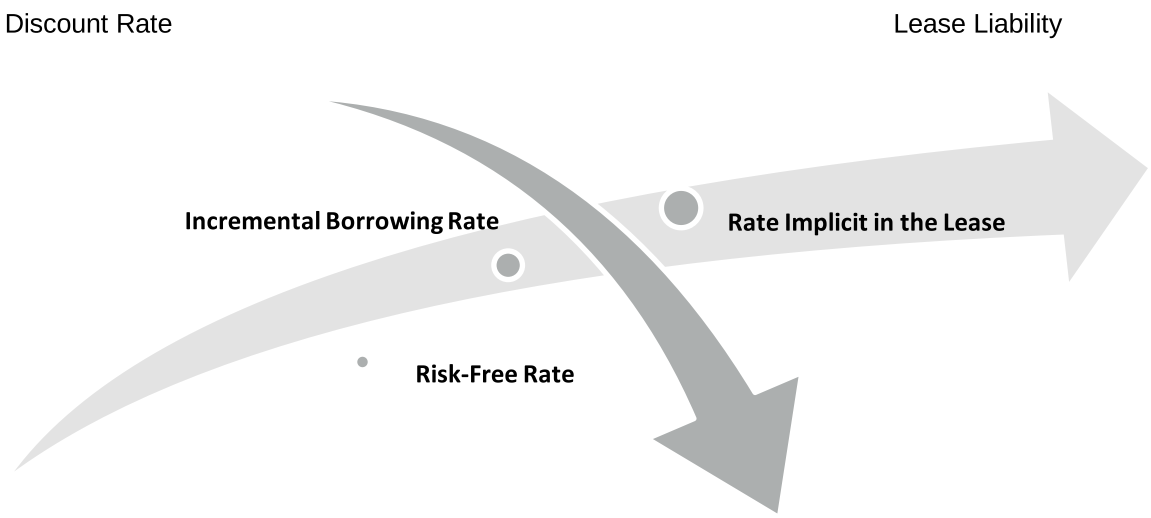
- Term – In general, if the term is longer, the rate will be higher (since the risk is higher).
- Timing of Payments – If more payments are made upfront, the risk—and rate—may be lower. The rate also would need to be adjusted to reflect any prepayment options.
- Collateral – The type of asset pledged as 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.

Discount Rate Relief

Risk-Free Rate Election – Nonpublic Entities

As originally issued, nonpublic entities were permitted to make an accounting policy election to use the risk-free rate when measuring their lease obligations; once elected it must be used consistently for all leases. Private companies and NFPs have expressed reluctance to use this relief on all leases. It also could cause leases that would otherwise be classified as operating leases to be classified as finance leases.

In November 2021, FASB issued Accounting Standards Update (ASU) 2021-09, which will allow lessees that are not public business entities to make the risk-free rate election by class of underlying asset rather than at the entity-wide level. If elected, the entity would be required to disclose which asset classes it has elected to apply a risk-free rate. For example, an entity may want to use its IBR for a material asset class, *e.g.*, real estate, but use the simpler and less costly option of using a risk-free rate for asset classes that have lower values or greater volumes of leases, *e.g.*, office equipment. ASU 2021-09 can be adopted at the same time as ASC 842. Special transition provisions apply if ASC 842 has already been adopted.



ASU 2021-09 also clarifies that when the rate implicit in the lease is readily determinable for an individual lease, the lessee would use that rate rather than the risk-free rate or an IBR, regardless of whether it has made the risk-free election.

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.

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 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.
- There is a change:

- in the lease term
- the assessment of whether the lessee will exercise or not exercise a purchase option
- in the probable amount the lessee will owe under a residual value guarantee

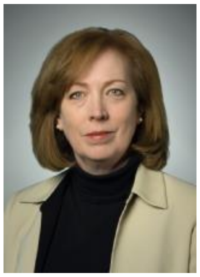
Disclosures

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.

Conclusion

For some entities, ASC 842's adoption will be complex and likely will require significant hours to implement correctly. **FORVIS** 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 us.

Contributor



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