Demystifying the Incremental Borrowing Rate

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In February 2016, the Financial Accounting Standards Board ("FASB") released Accounting Standards Update ("ASU") 2016-02, which provided the finalized standards related to lease accounting under Accounting Standards Codification Topic 842, *Leases* ("ASC 842"). Subsequent Accounting Standards Updates have been issued in order to provide additional clarity on specific issues pertaining to lease reporting, which are beyond the scope of this article. ASC 842 pertains to both lessors and lessees, but valuation requirements resulting from the recently implemented standard mostly impacts lessees. Therefore, this article will be focused primarily on valuation issues which are relevant to lessees.

In most cases, the primary impact of ASC 842 on lessees is the recognition of right-of-use ("ROU") assets and liabilities on the balance sheet. Upon adoption, the amount of the ROU lease liability is initially measured via the present value of remaining lease payments over the lease term. Similarly, the liabilities associated with new leases are measured as the present value of lease payments over the contractual term of the lease. The fair values of ROU lease liabilities also need to be reassessed whenever modifications occur to existing leases. This calculation is relatively straight forward as future lease payments and lease terms are stipulated in lease agreements. However, in order to calculate the present value of future lease payments, a discount rate is needed. This component of the discounted future lease payments analysis requires subjectivity on the part of filers and their valuation specialists.

Implementation dates for ASC 842 and the related ASUs vary, but publicly traded companies were generally required to implement the new standard for fiscal years (and the associated interim periods) beginning after December 15, 2018. Private companies were originally required to implement the new standard for fiscal years beginning after December 15, 2019. However, on October 18, 2019, the FASB extended the implementation date for private companies, not-for-profit organizations, and certain small publicly traded companies to fiscal years starting January 1, 2021.[1]

Discount Rate

When determining the appropriate discount rate needed to calculate the ROU lease liability, lessees should first consider the interest rate implied within the lease terms, if readily determinable. In certain cases, such as a sale and leaseback transaction, the fair value of the property sold can be used in conjunction with the projected lease payments over the term of the lease and an estimated residual asset value at the end of the lease term to "backsolve" to the implied interest rate of the lease. This discounted lease payment calculation is relatively easy to construct and requires less professional judgment. However, in situations

[1] https://www.fasb.org/cs/Satellite?c=FASBContent_C&cid=1176173615325&pagename=FASB%2FFASBContent_C%2FNewsPage

where the fair value of the leased asset is unknown, lessees are unlikely to have access to the information needed to assess the implied interest rate, including investment tax credits and deferred up-front direct costs for the lessor.

When an implied interest rate cannot be determined, the incremental borrowing rate ("IBR") of the lessee would then be used to determine the present value of future lease payments. ASC 842 also allows for a practical expedient, wherein privately-owned companies may use the yield on zero coupon U.S. Treasury securities (with a maturity date equivalent to that of the lease term) as an alternative to determining the IBR. The decision to use a risk-free rate or the IBR will often depend on a company's intentions for a liquidity event. For private entities that may be seeking liquidity via an initial public offering or sale to a publicly traded entity, establishing the ROU lease liability using the IBR may be preferred due to the reporting requirements of a publicly traded entity, which cannot use the practical expedient. Thus, the use of the risk-free rate may be most applicable for private entities that do not anticipate an exit event via the public markets.

What is the Incremental Borrowing Rate?

In order to understand what the IBR is and what considerations need to be included in determining this rate, we need to examine its definition as per ASC 842:

> *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.*

Unfortunately, detailed guidance on factors that specifically should be considered have not been provided by the FASB. The determination of the IBR is, therefore, subject to the interpretation of clients, their valuation specialists, and auditor. Breaking down this definition further by component, MPI believes that the IBR should consider three broad factors:

1. The interest rate on a secured form of debt (including consideration of a lessee's credit risk);
2. Contractual term (time) associated with each lease; and
3. The external conditions impacting the lessor, which would include the relevant economic and industry environment.

These components are interrelated and require professional judgment to assess a lessee's credit risk and, ultimately, the appropriate IBR.

How is the Incremental Borrowing Rate Determined?

Since the IBR is specific to the lessee, the credit risk associated with the lessee needs to be considered in determining the appropriate rate. One of the key initial steps of this process includes identifying the entity ultimately responsible for making the lease payments. For example, if the corporate parent guarantees fulfillment of lease obligations, the parent's creditworthiness should be considered in determining the

IBR. Identifying the responsible party is important in that it may also influence the need to consider adjustments for other external conditions, such as sovereign credit risk. In cases involving a guarantee at the corporate parent level located within the U.S., separate consideration around sovereign credit risk would (generally) be unnecessary.[2 3] However, if the lease obligation lies with individual operating subsidiaries located in countries outside of the U.S., the assessment of the IBR for the lessee would need to explicitly consider additional risks, such as sovereign credit risk and foreign currency risk, among others.

The starting point for estimating credit risk is the lessee's credit rating. A credit rating from a major credit-rating agency arguably provides the strongest basis for determining the credit-risk of the lessee. When such rating is unavailable, a synthetic credit rating analysis should be performed. There are a number of methods available to estimating a lessor's credit rating. Central to such methods is an examination of various liquidity, leverage, and solvency ratios based on a lessee's historical financial metrics in comparison to industry peers with publicly issued debt securities. A ratio analysis should also consider the impact of the lease itself to the credit worthiness of the lessee. The selected credit rating is used as a basis for gathering yields on debt securities issued by peers with comparable ratings in a similar industry (or as close as possible) and in the relevant sovereign jurisdiction. A "yield curve" is then generated to provide a benchmark for rates over varying terms.

Since corporate debt securities are often unsecured, the observed yields must then be adjusted to reflect a collateralized basis. Secured debt rates are typically lower than unsecured rates due to the additional layer of protection against default that the collateral provides to the debt holder. This adjustment should consider the lessee's cost of any existing collateralized and uncollateralized debt with third-parties. The extent and quality of the lessee's assets available as collateral are also important factors to consider.

Ultimately, the culmination of the factors discussed above results in a discount rate which may be used to comport with the requirements of ASC 842.

How MPI Can Help

As noted previously, the IBR is determined for existing leases at the date of adoption, at the time new leases are established, and whenever existing lease terms are modified, among other situations. For many companies, this may necessitate a fair value measurement exercise one or more times a year. Therefore, it is important to establish a process by which lessee's IBR can be efficiently estimated on a regular basis to determine the value of the ROU liability. MPI has the tools and resources in place to create a customized yield curve for our clients requiring this assistance. A critical step to building a repeatable model includes active collaboration between the client, auditor, and third-party valuation advisor, ensuring that all relevant factors are considered and addressed. The professionals at MPI understand the importance of this collaboration, as well as the audit review process, and can help you to smoothly make the transition

2 ASU 2016-02, example 842-20-55-20.

3 While sovereign credit spreads would not be explicitly considered in this case, exposure to different geographic markets and the risks therein should be considered within the context of the credit risk for the parent company as a whole.

to ASC 842. Contact us today with any questions regarding your valuation requirements or the contents of this article.

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