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Don’t Get Left Behind: Understanding the Incremental Borrowing Rate (IBR)

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Introduction of the speakers

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Agenda

1. Setting the scene
2. Understanding the IBR
3. Key takeaways

Why is ASC 842 introduced?

Need for transparency on entities' leasing activities and how these are financed led to ASC 842

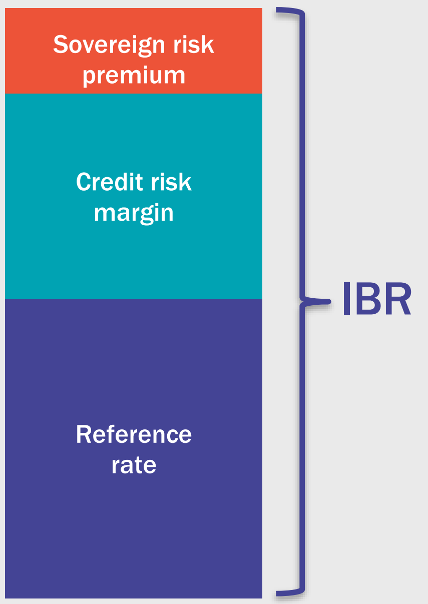
The new accounting standard requires all leases to be activated on the balance sheet in order to obtain this transparency

Activating a lease on the balance sheet requires calculating the NPV of the lease, i.e. the discounted value of all future lease payments

An IBR is the discount rate used for this NPV calculation and is dependent on:

- The characteristics of the lease
- The creditworthiness of the lessee

The components of the IBR



What is the impact on your financial statements?

Balance sheet	Impact	Comment
Leased assets	↑	Inclusion of the right-of-use assets
Financial liabilities	↑	Inclusion of NPV of future lease payments
Key Ratio's	**Impact**	**Comment**
EBITDA	↑ =	IFRS 16: Increase because expenses for off balance sheet leases are excluded. (ASC 842: no impact!)
EBIT	↑ =	IFRS 16: Increase because the depreciation charge added is lower than the expense for off balance sheet leases excluded. (ASC 842: no impact!)
Profit before tax	=	Only small changes are expected on the profit before tax
Gearing	↑	Increase because financial liabilities increase (and equity is expected to decrease).
Current ratio	↓	Decrease because current lease liabilities increase while current assets do not.

Discussion points

1. When to use a granular or conservative approach?

2. How to calculate the IBR given your approach?

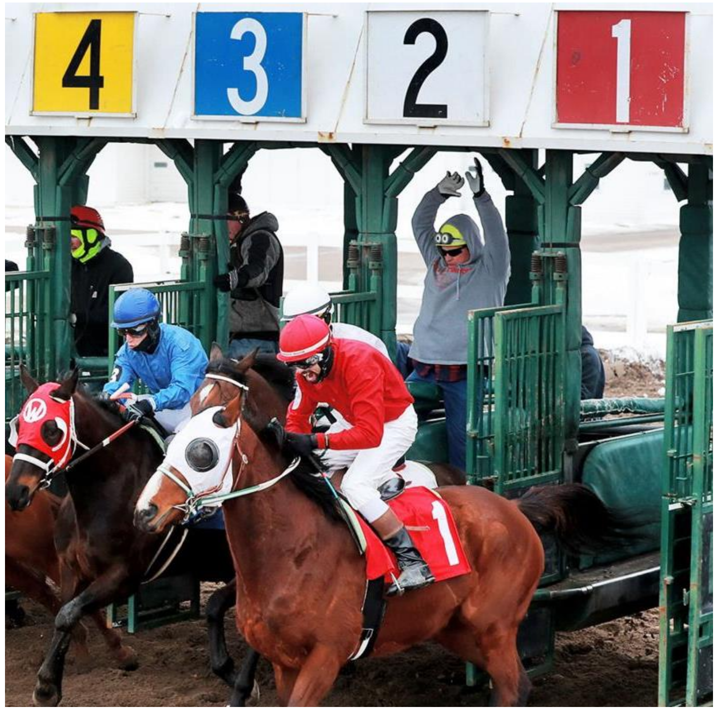
3. How to document your IBR processes?

How to approach the IBR?

Different horses for courses…

Granular approach

- Lessee & lease specific
- Manages the effect on the balance sheet
- Requires more data and effort



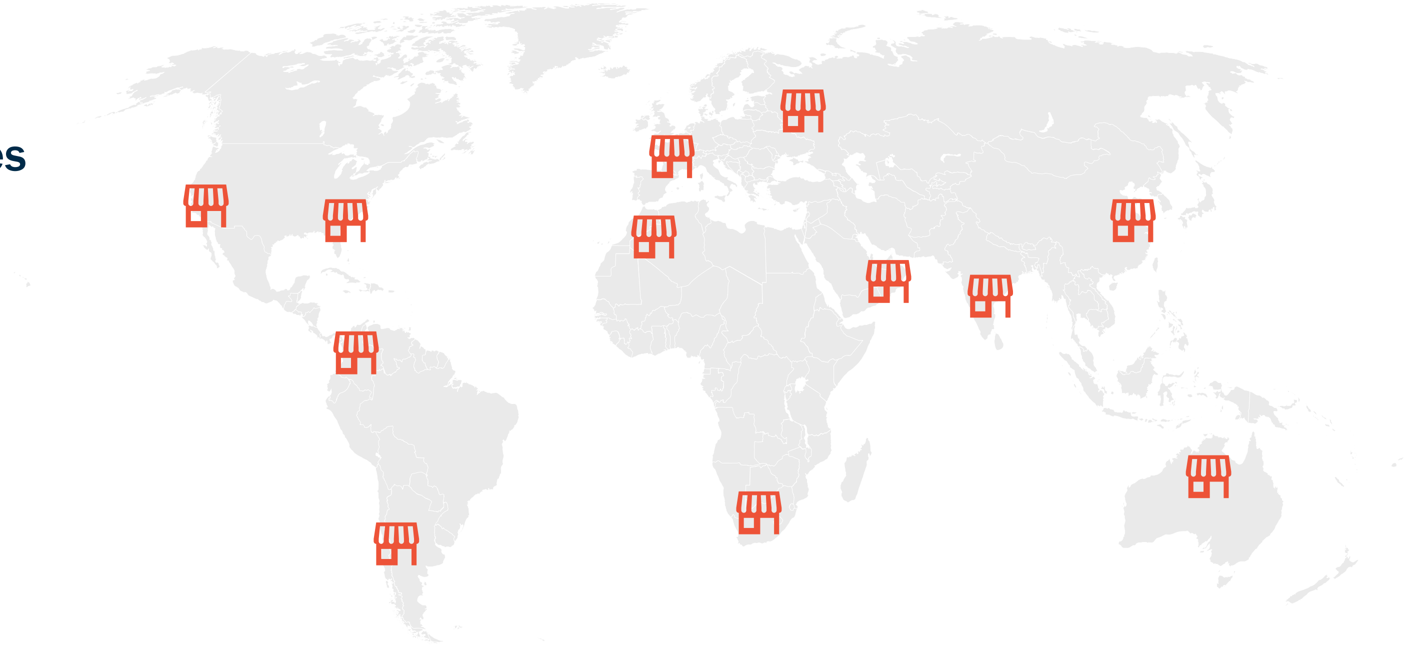
Conservative approach

- Reliant on a parent guarantee
- Conservative approach to liabilities is more expensive
- Relatively straightforward

In practice…

European case study

- Global leader in optical retailing
- Turnover: EUR 3.7 billion
- Over 8,000 retail locations across 40 countries



US case study

- Global apparel retailer
- Turnover: USD 5.5 billion
- 3,000 brand-dedicated shops
- Products sold in more than 110 counties

Agenda

1. Setting the scene
2. **Understanding the IBR**
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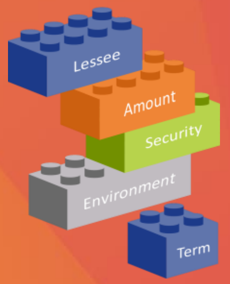
ASC 842 - The IBR

The ASC 842 guidelines clearly define IBR (see quote). This discount rate is the result of five building blocks:

The **lessee**, reflected in a company-specific credit rating (i.e. creditworthiness of the company)	
The **term** of the lease arrangement (i.e. tenor)	
The **amount** of the funds 'borrowed'	
The **security** granted to the lessor, which is the nature and quality of the underlying asset	
The **economic environment**, encompassing **jurisdiction**, **currency** and **date** at which the lease is entered into.	

Zanders has developed an ASC 842 methodology and solution based on these five building blocks for calculating the IBR.



"The incremental borrowing rate is the rate of interest that a <u>lessee</u> would have to pay to borrow on a <u>collateralized basis</u> over a similar <u>term</u> an <u>amount</u> equal to the lease payments in a similar <u>economic environment</u>."

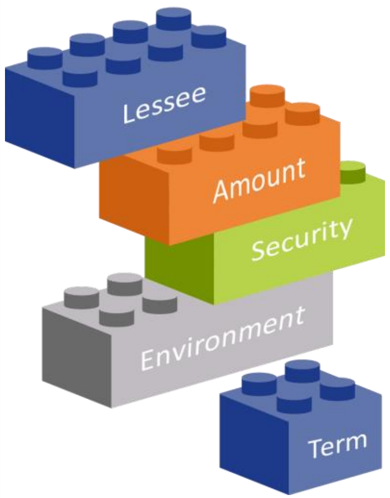
ASC 842, page 23

How to solve the IBR problem?

ASC 842 introduces a lease-specific calculation for the incremental borrowing rate.

5 building blocks

...that determine the IBR calculation.



Creditworthiness of the lessee

- Financial ratio's
- Qualitative information
- Group support analysis

Characteristics of the lease

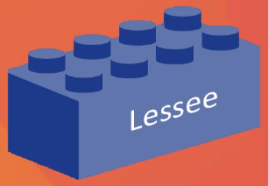
- Amount
- Security
- Environment
- Term

1 IBR

... for each of your lease transactions.

A portfolio approach may be applied when all characteristics are similar.

Block 1: the lessee



Granular approach

- Creditworthiness determined for each lessee, i.e. a company-specific credit rating[1]
- Takes into account qualitative and quantitative aspects of the company
- The stand-alone credit rating of a subsidiary will be adjusted in case of any implicit or explicit group support.

Conservative approach

- Use of the credit rating of the parent for all leases

"The incremental borrowing rate is the rate of interest that a <u>lessee</u> 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."

ASC 842, page 23

1: according to ASC 842, page 114

Block 2: the term

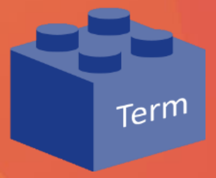
Granular approach

- The term of the lease arrangement (i.e. tenor) is used to determine the IBR.
- A lessee remeasures the lease liability at the date of reassessment using a revised discount rate when there is a change in the lease term.[1]

Conservative approach

- Grouping of terms into wider buckets to determine a limited amount of IBR's.

1: according to ASC 842, page 32



"The incremental borrowing rate is the rate of interest that a lessee would have to pay to borrow on a collateralized basis over a similar <u>term</u> an amount equal to the lease payments in a similar economic environment."

ASC 842, page 23

Block 3: the amount

Granular approach

- The amount of the funds ‘borrowed’ is taken into account in the lessee-specific financials (i.e. has an effect on the amount of debt of the lessee)
- The amount is reflected by the funds necessary to obtain an asset of similar value of the right-to-use asset.

Conservative approach

- The amount is not taken into account when determining the IBR, i.e. the IBR is the same for all leases when all other characteristics are the same.

“The incremental borrowing rate is 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.”

ASC 842, page 23

1: according to ASC 842, page 114
2: according to ASC 842, page 32

Block 4: the security

Granular approach

- The security granted to the lessor, which is the nature and quality of the leased asset
- The type of the underlying asset has impact on the level of security that is granted to the lessor, which is reflected by the Loss Given Default (LGD)
- The higher the LGD of the underlying asset, the riskier the lease (i.e. this can be explained by the recovery rate, which is 1 -/- LGD). The riskier the lease, the higher the IBR for ASC 842 purposes.

Conservative approach

- An overall credit risk assessment is used for all types of leases (i.e. property, vehicles, equipment, etc.).

"The incremental borrowing rate is the rate of interest that a lessee would have to pay to borrow on a <u>collateralized</u> basis over a similar term an amount equal to the lease payments in a similar economic environment."

ASC 842, page 23

1: Basel Committee on Banking Supervision, December 2017, Basel III reforms

Block 5: economic environment

Granular approach

- Taking into account the economic environment of each lease
- A lease is contracted in a certain jurisdiction or country, therefore the IBR needs to be adjusted for country-specific risk.
- The IBR should be determined using the currency of the lease contract.
- A lessee remeasures the lease liability at the date of reassessment using a revised discount rate as it affects the components of the IBR. [1]

Conservative approach

- No or limited distinction between countries and currencies

"The incremental borrowing rate is 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**."

ASC 842, page 23

1: according to ASC 842, page 6 - 7

Comply with ASC 842 by leveraging automation

A four-step approach for determining the incremental borrowing rate:

1 Lease input

The company collects all lessee financials and relevant data about the lease (portfolio).

2 Credit rating assessment

The credit rating of the lessee is calculated over the provided financials information.

3 IBR assessment

The appropriate incremental borrowing rate is determined based on the characteristics of the lease portfolio and the lessee credit rating.

4 ASC 842 IBR report

The methodology should be documented for audit purposes in an ASC 842 IBR report.

Agenda

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Key takeaways

From building blocks to a build-up approach

1. Different horses for different courses
    - Taking the granular or conservative approach? Depends on:
        - the company profile
        - the characteristics of your lease portfolio
        - the effect on the balance sheet
    - ‘Hybrid’ methodology is possible, where a portfolio approach is chosen for some building blocks

2. Automating calculations
    - Automating IBR calculations allows saving time while gaining accurateness

3. Align the IBR approach with your auditor
    - Prepare transparent documentation to outline the used method

Questions?

Contact us!

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Appendix

Appendix (1/5)

ASC 842, page 5:

Under Topic 842, the critical determination is whether a contract is or contains a lease because lessees are required to recognize lease assets and lease liabilities for all leases— finance and operating—other than short-term leases (that is, if the entity elects the short-term lease recognition and measurement exemption).

ASC 842, page 13:

An entity shall apply this topic to all leases, including subleases…

Appendix (2/5)

ASC 842, page 35:

At the commencement date, the lease payments shall consist of the following payments relating to the use of the underlying asset during the lease term:

a. Fixed payments, including in substance fixed payments, less any lease incentives paid or payable to the lessee (see paragraphs 842-10-55-30 through 55-31).

b. Variable lease payments that depend on an index or a rate (such as the Consumer Price Index or a market interest rate), initially measured using the index or rate at the commencement date.

c. The exercise price of an option to purchase the underlying asset if the lessee is reasonably certain to exercise that option (assessed considering the factors in paragraph 842-10-55-26).

d. Payments for penalties for terminating the lease if the lease term (as determined in accordance with paragraph 842-10-30-1) reflects the lessee exercising an option to terminate the lease.

e. Fees paid by the lessee to the owners of a special-purpose entity for structuring the transaction. However, such fees shall not be included in the fair value of the underlying asset for purposes of applying paragraph 842-10-25-2(d).

f. For a lessee only, amounts probable of being owed by the lessee under residual value guarantees (see paragraphs 842-10-55-34 through 55- 36).

Appendix (3/5)

ASC 842, page 32:

A lessee shall reallocate the remaining consideration in the contract and remeasure the lease liability using a discount rate for the lease determined at the effective date of the modification if a contract modification does any of the following: a. Grants the lessee an additional right of use not included in the original contract (and that modification is not accounted for as a separate contract in accordance with paragraph 842-10-25-8) b. Extends or reduces the term of an existing lease (for example, changes the lease term from five to eight years or vice versa), other than through the exercise of a contractual option to extend or terminate the lease (as described in paragraph 842-20-35-5) c. Fully or partially terminates an existing lease (for example, reduces the assets subject to the lease) d. Changes the consideration in the contract only.

ASC 842, page 114:

… lessee can apply a single discount rate to the portfolio of new leases. This is because during the period, the new leases are all of similar terms (four to five years), and Lessee's credit rating and the interest rate environment are stable."

Appendix (4/5)

ASC 842, page 6-7:

In transition, lessees and lessors are required to recognize and measure leases at the beginning of the earliest period presented using a modified retrospective approach. The modified retrospective approach includes a number of optional practical expedients that entities may elect to apply. These practical expedients relate to the identification and classification of leases that commenced before the effective date, initial direct costs for leases that commenced before the effective date, and the ability to use hindsight in evaluating lessee options to extend or terminate a lease or to purchase the underlying asset. An entity that elects to apply the practical expedients will, in effect, continue to account for leases that commence before the effective date in accordance with previous GAAP unless the lease is modified, except that lessees are required to recognize a right-of-use asset and a lease liability for all operating leases at each reporting date based on the present value of the remaining minimum rental payments that were tracked and disclosed under previous GAAP.

Appendix (5/5)

ASC 842, page 23:

“For a lessee, the discount rate for the lease is the rate implicit in the lease unless that rate cannot be readily determined. In that case, the lessee is required to use its incremental borrowing rate.”

ASC 842, page 23:

“The incremental borrowing rate is 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.”