

Alerte de votre conseiller – *Aperçu d'IFRS 16 – Comprendre le taux d'actualisation*

Novembre 2018

Aperçu

L'équipe IFRS de Grant Thornton International a publié le bulletin *Insights into IFRS 16 – Understanding the discount rate* (en anglais seulement).

La série *Insights into IFRS 16* fournit des informations sur l'application d'IFRS 16, *Contrats de location*, dans des domaines clés. Chaque édition mettra l'accent sur un aspect d'IFRS 16 afin de vous aider à vous préparer aux changements apportés par l'adoption de la norme.

Ce premier bulletin donne des indications concernant la détermination du taux d'actualisation.

Enjeu

Selon la norme IFRS 16, des taux d'actualisation sont nécessaires pour évaluer l'obligation locative d'un preneur à la valeur actualisée des paiements de loyers. Des taux d'actualisation sont également utilisés pour déterminer le classement des contrats de location par un bailleur et pour évaluer l'investissement net d'un bailleur dans un contrat de location-financement.

Le bulletin explore les différentes méthodes prescrites dans IFRS 16 pour déterminer les taux d'actualisation et présente des points de vue pour vous aider à comprendre les méthodes.

Ressource

Le bulletin *Insights into IFRS 16 – Understanding the discount rate* est joint à la présente *Alerte de votre conseiller*.

À propos de Raymond Chabot Grant Thornton

Raymond Chabot Grant Thornton S.E.N.C.R.L. est un cabinet comptable et de consultation de premier plan qui fournit aux sociétés fermées et ouvertes des services de certification et de fiscalité et des services-conseils. Ensemble, Raymond Chabot Grant Thornton S.E.N.C.R.L. et Grant Thornton LLP au Canada comptent plus de 4 400 professionnels répartis dans tout le Canada. Raymond Chabot Grant Thornton S.E.N.C.R.L. est un cabinet membre de Grant Thornton International Ltd (Grant Thornton International). Grant Thornton International et les cabinets membres ne constituent pas une association mondiale. Les services sont offerts de façon indépendante par les cabinets membres. Nous avons fait tous les efforts afin de nous assurer que l'information comprise dans la présente publication était exacte au moment de sa diffusion. Néanmoins, les informations fournies ou les opinions exprimées ne constituent pas une prise de position officielle et ne devraient pas être considérées comme un conseil technique pour vous ou votre organisation sans l'avis d'un conseiller d'affaires professionnel. Pour de plus amples renseignements à ce sujet, veuillez contacter votre conseiller chez Raymond Chabot Grant Thornton.

Insights into IFRS 16

Understanding the discount rate

Under IFRS 16 'Leases', discount rates are used to determine the present value of the lease payments used to measure a lessee's lease liability. Discount rates are also used to determine lease classification for a lessor and to measure a lessor's net investment in a lease.

For lessees, the lease payments are required to be discounted using:

- the interest rate implicit in the lease (IRIL), if that rate can be readily determined, or
- the lessee's incremental borrowing rate (IBR).

For lessors, the discount rate will always be the interest rate implicit in the lease.

The **interest rate implicit in the lease** is defined in IFRS 16 as 'the rate of interest that causes the present value of (a) the lease payments and (b) the unguaranteed residual value to equal the sum of (i) the fair value of the underlying asset and (ii) any initial direct costs of the lessor.'

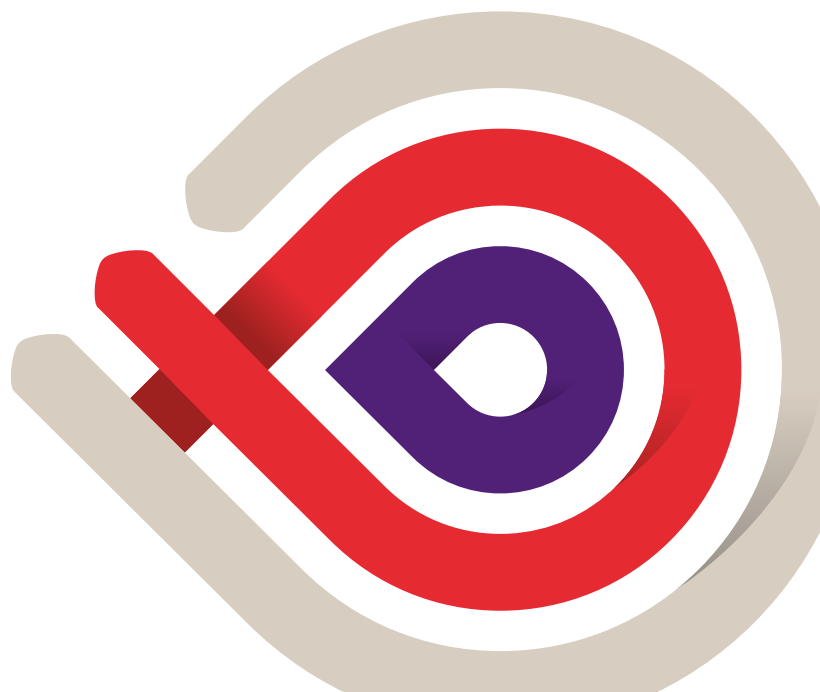
The **lessee's incremental borrowing rate** is defined in IFRS 16 as 'the rate of interest that a lessee would have to pay to borrow over a similar term, and with a similar security, the funds necessary to obtain an asset of a similar value to the right-of-use asset in a similar economic environment'.

The incremental borrowing rate is determined on the commencement date of the lease. As a result, it will incorporate the impact of significant economic events and other changes in circumstances arising between lease inception and commencement.

A lessee will need to determine a discount rate for virtually every lease to which it applies the lessee accounting model in IFRS 16. However, a discount rate may not need to be determined for a lease if:

- a lessee applies the recognition exemption for either a short-term or a low-value asset lease
- all lease payments are made on (or prior to) the commencement date of the lease, or
- all lease payments are variable and not dependent on an index or rate (eg, all lease payments vary based on sales or usage).

The interest rate implicit in the lease may be similar to the lessee's incremental borrowing rate in many cases. Both rates consider the credit risk of the lessee, the term of the lease, the security and the economic environment in which the transaction occurs.



Interest rate implicit in the lease

The definition of interest rate implicit in the lease is the same for both a lessee and a lessor. Because it is based in part upon the initial direct costs of the lessor, it will often be difficult and in many cases impossible for the lessee to readily determine the interest rate implicit in the lease.

For some leases, including most property leases, a lack of detailed information about the fair value of the underlying asset, the expected residual value of the asset at the end of the lease term and any initial direct costs of the lessor will make it difficult or impossible for the lessee to readily determine the interest rate implicit in the lease.

In other cases, the lessee may be able to obtain the relevant information from the lessor during the lease negotiation process. The initial fair value of the underlying asset and residual value of the underlying asset may also be determinable from a reliable external source. The lessee may be able to reasonably determine that the lessor's initial direct costs would not be significant to the overall arrangement. In leasing transactions between related parties, it is likely that most or all of the relevant information can be obtained by the lessee.

While it is relatively common for some traditional equipment finance leases to make explicit reference to an interest rate in the lease documentation, caution is warranted. This rate will not represent the interest rate implicit in the lease if it doesn't include an estimate of residual value for the underlying asset or take the lessor's initial direct costs into account.

What is readily determinable?

The interest rate implicit in the lease must be used only if that rate can be readily determined. The meaning of the term 'readily determinable' is open to some interpretation.

Sometimes, particularly in relation to leases of real estate, the lessee uses a valuation expert to determine the interest rate implicit in the lease. In our view, rates determined by experts would not qualify as readily determinable and the lessee should be using its incremental borrowing rate instead.

Similarly, where the interest rate implicit in the lease can only be determined by including significant estimates and assumptions, a lessee would likely conclude that the interest rate implicit in the lease is not readily determinable.

The impact of variable lease payments on the interest rate implicit in the lease

Variable lease payments can impact the calculation of the interest rate implicit in the lease. Only variable payments based on an index or rate should be included in the calculation of the interest rate implicit in the lease (ie. variable payments that are included in the definition of lease payments). True variable payments, such as those based on sales or usage, must be excluded. Unfortunately, this can result in rates that are potentially misleading if the lease agreement is structured in a way that most payments are variable. If the calculated interest rate implicit in the lease is negative or otherwise doesn't make sense, in our view the incremental borrowing rate should be used.

Lessee's incremental borrowing rate

Where the lessee is unable to readily determine the interest rate implicit in the lease, the discount rate will be the lessee's incremental borrowing rate. The incremental borrowing rate is an interest rate specific to the lessee that reflects:

- the credit risk of the lessee
- the term of the lease
- the nature and quality of the security
- the amount 'borrowed' by the lessee, and
- the economic environment (the country, the currency and the date that the lease is entered into) in which the transaction occurs.

With significant judgement required to assess many of the factors noted above, we expect this to be a challenging area in practice.

It is important to note that the lessee needs to determine the incremental borrowing rate for the right-of-use asset, not the underlying physical asset.

In most cases, the lessee will need to determine its incremental borrowing rate separately for each lease. Exceptions are where:

- as a practical expedient, the entity applies lease accounting to a portfolio of leases that have similar characteristics. IFRS 16 allows this practical expedient if the effect is reasonably expected to be materially the same as a lease-by-lease approach, or
- on transition, using the modified retrospective approach, a lessee applies a single discount rate to a portfolio of leases with reasonably similar characteristics (such as leases with a similar remaining lease term for a similar class of underlying asset in a similar economic environment).

It would not be appropriate for a lessee to use its weighted average cost of capital (WACC), which includes equity as well as borrowings. An entity's weighted average cost of capital is not specific to the term, security and amount of the lease.

It would also not be appropriate for a lessee to use its parent's incremental borrowing rate instead of calculating and determining its own rate.

If a lessee has direct borrowings, the effective interest rate on those borrowings may serve as a helpful starting point for determining the incremental borrowing rate. However, it is important to appreciate this is a starting point and adjustments are likely to be necessary. The interest rate on the direct borrowings may have been determined at a date when market conditions and the credit risk of the lessee were different than they are on the commencement date of the lease, or the borrowing may have been based on a different term or included different security. Substantial adjustment may be required (in either direction) to the interest rate on direct borrowings to determine an appropriate incremental borrowing rate and significant judgement will be involved in making these adjustments.

The interest rate implicit in a lease often incorporates an ‘asset risk premium’ reflecting the lessor’s exposure to the residual value of the asset at the end of the lease term. As these premiums reflect the risks and circumstances of the lessor, they should be ignored when estimating the lessee’s incremental borrowing rate.

There is an additional complexity involving the way in which a loan’s principal will be repaid. For example, a lender charging 8% for a fully amortising loan (ie, blended payments of principal and interest over the loan term) may charge a

different rate for a ‘bullet-style’ loan where the principal is repaid all at once at the end of the loan’s term. Unfortunately, the Standard has no guidance on whether the lessee is required to base its analysis on rates applicable to fully amortising loans, or whether rates for bullet-style loans might also provide a meaningful starting point in assessing incremental borrowing rate. While most leases are likely to involve payment streams similar to an amortising loan, lessees will need to exercise careful judgement and consider all facts and circumstances relevant to their situation.

Example – Blended rates

An entity purchases a building. Assume that a loan-to-value (LTV) ratio of 80% applies, ie, the lender is only willing to provide funding for 80% of the appraised value of the building in a secured borrowing. If the entity chooses to finance 100% of the purchase it will need to finance the remaining 20% at a higher rate using an unsecured borrowing.

Now assume that instead of purchasing the building, the entity decides to lease it for a period of 10 years and that a similar LTV ratio applies (ie, the lender is only willing to provide funding for 80% of the estimated value of the right-of-use asset). How should the lessee estimate its incremental borrowing rate?

Analysis

The lessee should use the rate at which it would finance 100% of the cost of the right-of-use asset. ie. $(80\% \times \text{rate for secured borrowing}) + (20\% \times \text{rate for unsecured borrowing})$. This is sometimes known as the blended rate.

Reassessments of the lease term and lease modifications

A lessee will need to revise the discount rate when there is a reassessment of the lease liability or a lease modification.

The revised discount rate is the interest rate implicit in the lease for the remainder of the lease term, unless it cannot be readily determined, in which case the lessee’s incremental borrowing rate at the date of reassessment or effective date of lease modification is used.

The lessee will remeasure the lease liability by discounting the revised lease payments using a revised discount rate, if either:

- there is a change in the lease term as a result of
 - a change in the non-cancellable period of the lease, eg the lessee exercises an option to extend that was not previously included in the lease term (or the lessee does not exercise such an option that was previously included in the lease term), or
 - a lessee reassessing whether it is reasonably certain to exercise an extension option or not to exercise a termination option, or
- there is a change in the assessment of a lessee’s option to purchase the underlying asset.

Transition

For leases previously classified as operating leases under IAS 17 where a lessee elects to apply IFRS 16 for the first time using the modified retrospective approach:

- the lessee recognises a lease liability at the date of initial application by discounting the remaining lease payments using its incremental borrowing rate at the date of initial application, and
- where the lessee elects to measure a right-of-use asset at its carrying amount as if IFRS 16 had been applied since the lease commencement date, the measurement is adjusted by discounting the lease payments using the lessee’s incremental borrowing rate at the date of initial application.

We expect that most lessees will use an incremental borrowing rate at transition that reflects a lease term based on the number of months remaining from the date of initial application. This is especially where an entity applies a single discount rate to a portfolio of former operating leases with reasonably similar characteristics. However, as the Standard is silent on this issue, some entities may choose to determine the incremental borrowing rate by reference to the original lease term measured from the lease commencement date.

Contact us

We hope you find the information in this article helpful in giving you some detail into aspects of IFRS 16. If you would like to discuss any of the points raised, please speak to your usual Grant Thornton contact or visit www.grantthornton.global/ locations to find your local member firm.



grantthornton.global

© 2018 Grant Thornton International Ltd. All rights reserved.

'Grant Thornton' refers to the brand under which the Grant Thornton member firms provide assurance, tax and advisory services to their clients and/or refers to one or more member firms, as the context requires. Grant Thornton International Ltd (GTIL) and the member firms are not a worldwide partnership. GTIL and each member firm is a separate legal entity. Services are delivered by the member firms. GTIL does not provide services to clients. GTIL and its member firms are not agents of, and do not obligate, one another and are not liable for one another's acts or omissions.