



## STAFF PAPER

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## IFRS® Interpretations Committee meeting

<b>Project</b>	<b>Lessee's Incremental Borrowing Rate (IFRS 16)</b>		
Paper topic	Agenda decision to finalise		
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## Introduction

1. In June 2019 the IFRS Interpretations Committee (Committee) published a [tentative agenda decision](#) about whether, applying IFRS 16 *Leases*, a lessee's incremental borrowing rate must reflect the interest rate in a loan with both a similar maturity to the lease and a similar payment profile to the lease payments.
2. The submitter explained that loans are generally either (a) amortising loans—paid down over time (principal and interest); or (b) bullet repayment loans—interest paid over time with a single bullet payment of the principal at the end of the loan. Interest rates for bullet repayment loans might often be higher than those for amortising loans.
3. In considering the question, the Committee observed that the definition of a lessee's incremental borrowing rate requires a lessee to determine its incremental borrowing rate for a particular lease considering the terms and conditions of the lease, and determine a rate that reflects the rate it would have to pay to borrow:
  - (a) over a similar term to the lease term;
  - (b) with a similar security to the security (collateral) in the lease;
  - (c) the amount needed to obtain an asset of a similar value to the right-of-use asset arising from the lease; and

- (d) in a similar economic environment to that of the lease.
4. Furthermore, the Committee observed that the definition of a lessee's incremental borrowing rate in IFRS 16 does not explicitly require a lessee to determine its incremental borrowing rate to reflect the interest rate in a loan with a similar payment profile to the lease payments. Nonetheless, the Committee observed that, in applying judgement in determining its incremental borrowing rate as defined in IFRS 16, a lessee might often refer as a starting point to a readily observable rate for a loan with a similar payment profile to that of the lease.
5. The objectives of this paper are to:
- (a) analyse the comments on the tentative agenda decision; and
  - (b) ask the Committee whether it agrees with our recommendation to finalise the agenda decision.
6. There are two appendices to this paper:
- (a) Appendix A—proposed wording of the agenda decision; and
  - (b) Appendix B— analysis of other comments.
7. Agenda Paper 8A for this meeting reproduces the comment letters.

### **Comment letter summary**

8. We received 15 comment letters by the comment letter deadline. All comment letters received, including any late comment letters, are available on our [website](#)<sup>1</sup>. This agenda paper includes analysis of only the comment letters received by the comment letter deadline. These are reproduced in Appendix B to this paper.
9. Six respondents (PwC, the Accounting Standards Committee of Germany (ASCG), KPMG, the Malaysian Accounting Standards Board, the Institute of Indonesia Chartered Accountants and the Institute of Chartered Accountants of Nigeria) agree

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<sup>1</sup> At the date of posting this agenda paper, there were no late comment letters.

with the Committee’s decision not to add the matter to its standard-setting agenda for the reasons set out in the tentative agenda decision. Two of these respondents (ASCG and KPMG) suggest improvements to the wording of the tentative agenda decision.

10. Five respondents (Mazars, the European Securities and Markets Authority (ESMA), BDO, Deloitte and EY) disagree with the Committee’s conclusion and think the requirements in IFRS 16, supported by the Basis for Conclusions, are sufficient for the Committee to conclude that a lessee’s incremental borrowing rate must reflect the payment profile of the lease. Furthermore:
  - (a) four of these respondents (ESMA, BDO, Deloitte and EY) suggest that if the Committee is unable to reach this conclusion, standard-setting should be undertaken;
  - (b) two of these respondents (Mazars and Deloitte) comment on the prevalence of readily observable interest rates for amortising loans; and
  - (c) ESMA comments on convergence with US GAAP.
11. The ANC agrees with the Committee’s conclusion that the definition of a lessee’s incremental borrowing rate does not explicitly require a lessee to determine its incremental borrowing rate to reflect the payment profile of the lease. However, to prevent diversity, the ANC suggests a narrow scope amendment to IFRS 16.
12. Petrobras disagrees with the Committee’s conclusion that the principles and requirements in IFRS 16 provide an adequate basis for an entity to determine its incremental borrowing rate. Petrobras suggests that IFRS 16 is amended to require a lessee’s incremental borrowing rate to reflect the payment profile of the lease.
13. Two respondents (the KASB and David Hardidge) comment on the clarity of the tentative agenda decision and mention, more generally, practice questions relating to a lessee’s incremental borrowing rate.
14. Further details about these matters, together with our analysis, are presented below.

## Staff analysis

### *Structure of our analysis*

15. This paper analyses separately comments that relate to:
  - (a) the Committee’s technical conclusion—specifically, comments from those respondents who think IFRS 16 requires a lessee’s incremental borrowing rate to reflect the payment profile of the lease (paragraphs 17-31 of this paper);
  - (b) requests for standard-setting (paragraphs 32-35 of this paper); and
  - (c) clarifications to the wording of the agenda decision (paragraphs 36-43 of this paper).
16. Appendix B to this paper analyses all other comments.

### *Committee’s technical conclusion*

#### *Respondents’ comments*

17. Mazars, ESMA, BDO, Deloitte and EY are of the view that the requirements in IFRS 16, supported by the Basis for Conclusions, are sufficient for the Committee to conclude that a lessee’s incremental borrowing rate must reflect the payment profile of the lease. These respondents provided the following rationale:
  - (a) **paragraph BC162:** all of these respondents refer to paragraph BC162, which states that the Board defined a lessee’s incremental borrowing rate “to take into account the terms and conditions of the lease”. The respondents think payment profile is a key term of the lease and, consequently, should be reflected in a lessee’s determination of its incremental borrowing rate.
  - (b) **paragraph BC160:** BDO, Deloitte and EY refer to paragraph BC160, in which the Board notes that its objective in specifying the discount rate to apply to a lease is to specify a rate that reflects how the contract is priced.

These respondents observe that the pricing of a lease is affected by the payment profile.

- (c) **definition of a lessee’s incremental borrowing rate—‘a similar term’:**  
 Deloitte and EY disagree with the Committee’s conclusion that the reference to ‘...a similar term’ in the definition of a lessee’s incremental borrowing rate refers only to ‘lease term’. These respondents think the reference to ‘...a similar term’ refers to all terms and conditions of the lease, thus including payment profile.
- (d) **definition of a lessee’s incremental borrowing rate—‘a similar economic environment’:** BDO thinks the reference to ‘...a similar economic environment’ in the definition of a lessee’s incremental borrowing rate is sufficient to require payment profile to be taken into account. This is because the payment profile will link to interest rates that vary according to their maturity and be determined by the interest rates that apply in the particular jurisdiction (and thus the economic environment).
- (e) **underlying economic principles:** ESMA thinks the underlying economic principles on which the IFRS 16 model is based require the payment profile to be reflected in a lessee’s incremental borrowing rate. ESMA refers to the objective of IFRS 16, which is to ensure that lessees provide relevant information in a manner that faithfully represents lease transactions.

*Staff analysis*

[Paragraph BC162](#)

18. In the tentative agenda decision, the Committee highlighted the explanation in paragraph BC162 and observed that a lessee might often refer as a starting point to a readily observable rate for a loan with a similar payment profile to that of the lease. However, the Committee also observed that IFRS 16 itself does not explicitly require a lessee to determine its incremental borrowing rate to reflect the interest rate in a loan with a similar payment profile to the lease payments.

19. Paragraph BC162 explains how the Board defined incremental borrowing rate in the Standard. We think the paragraph provides helpful context for entities applying that definition, but it does not introduce additional requirements. Specifically, paragraph BC162 states that (**emphasis added**) “the **IASB decided to define** the lessee’s incremental borrowing rate to take into account the terms and conditions of the lease”. The paragraph explains the Board’s decision but does not introduce a requirement for entities to reflect all terms and conditions of a lease (specifically, payment profile) when determining incremental borrowing rate.
20. Consequently, we continue to support the Committee’s view that the definition of a lessee’s incremental borrowing rate in IFRS 16 does not explicitly require a lessee to determine its incremental borrowing rate to reflect the interest rate in a loan with a similar payment profile to the lease payments.

#### Paragraph BC160

21. Similar to the above analysis, we note that paragraph B160 explains (**emphasis added**) ‘the **IASB’s objective** in specifying the discount rate to apply to a lease is to specify a rate that reflects how the contract is priced’. The paragraph does not contain any requirements for entities. Consequently, we think it is not possible to conclude from this paragraph that a lessee must reflect the payment profile when determining its incremental borrowing rate.

#### Definition of a lessee’s incremental borrowing rate—‘a similar term’

22. We disagree with Deloitte and EY that the words ‘a similar term’ in the definition of a lessee’s incremental borrowing rate refers to all terms and conditions of the lease for the following reasons:
- (a) the definition of a lessee’s incremental borrowing rate refers to ‘term’ in the singular. In other words, the definition refers to one term only (ie the lease term) and not multiple terms (ie all contractual terms of the lease).
  - (b) throughout IFRS 16, when the Board intended to refer to ‘terms and conditions of the lease’, it used those exact words. For example, the IFRS 16 definitions of both ‘inception date’ and ‘lease modification’ refer

to the ‘terms and conditions of the lease’. IFRS 16 was drafted in this way with the objective of creating a distinction between lease term (as defined) and the terms and conditions of a lease.

23. Consequently, we conclude that to read ‘a similar term’ to mean ‘similar terms and conditions’ would go beyond the words in the Standard.

#### Definition of a lessee’s incremental borrowing rate—‘a similar economic environment’

24. ‘Economic environment’ refers to the economic factors that affect commercial and consumer behaviour. We agree with BDO that prevailing interest rates in a particular jurisdiction form part of the economic environment.

25. However, we think the same is not true of payment terms. We think in many jurisdictions a lessee would be able to negotiate a range of payment terms (eg bullet repayment, payments over time, or something in between). For example, a lessee might negotiate a bullet repayment arrangement by agreeing to pay a higher interest rate compared to the market rate for a similar lease with payments over time. Such a negotiation would not be a direct consequence of the economic environment.

26. Consequently, we conclude that the reference to ‘similar economic environment’ in the definition of a lessee’s incremental borrowing rate does not require a lessee to reflect the payment profile of the lease in determining that rate.

#### Underlying economic principles

27. ESMA is of the view that a proper reflection of the payment profile is necessary to faithfully represent the economic characteristics of a lease.

28. As noted in paragraph 2.18 of the *Conceptual Framework for Financial Reporting*, faithful representation ‘does not mean accurate in all respects’. Estimating amounts in financial statements when they cannot be observed directly does not prevent achieving a faithful representation. We note that a lessee’s incremental borrowing rate is used only when the rate implicit in the lease cannot be readily determined and is, therefore, an estimate.

29. Furthermore, in developing IFRS 16, the Board was mindful of the cost and complexity concerns raised by stakeholders throughout the project and, as noted in paragraph BC18, took steps to address these.
30. We continue to support the Committee’s conclusion that the definition of a lessee’s incremental borrowing rate does not require reflection of the payment profile, even though in applying judgement in determining that rate, we might expect a lessee to do so in many cases. Applying the definition does not prevent an entity from achieving a faithful representation of its leases.

*Staff conclusion*

31. In the light of the above analysis, we recommend no change to the tentative agenda decision regarding the matters raised by those respondents who think a lessee’s incremental borrowing rate must reflect the payment profile of the lease.

***Request for standard-setting activity***

*Respondents’ comments*

32. Further to their views described in paragraph 17 above, ESMA, BDO, Deloitte and EY suggest that if the Committee is unable to conclude that a lessee’s incremental borrowing rate is required to reflect the payment profile of the lease, then standard-setting should be undertaken. Such standard-setting activity could clarify in IFRS 16 that a lessee’s incremental borrowing rate is required to reflect the payment profile of the lease. Petrobras also suggests amending IFRS 16 in this way.
33. The ANC asks the Committee to consider recommending a narrow scope amendment to IFRS 16 that would set into the Standard the methodology that best reflects the economics of the borrowing.

*Staff analysis*

34. We continue to agree with the Committee’s conclusion that IFRS 16 provides an adequate basis for an entity to determine a lessee’s incremental borrowing rate. This is consistent with the Board’s decision not to include application guidance on the



topic when developing IFRS 16. Furthermore, as described in our initial consideration ([June 2019 Agenda Paper 2](#)), determining a lessee's incremental borrowing rate is not an exact science—it involves estimation considering many factors (a number of which are mentioned in comment letters). Consequently, any standard-setting activity that would focus narrowly on only one aspect of determining a lessee's incremental borrowing rate has the potential to do more harm than good.

35. If there were to be a need for the Board to address a lessee's incremental borrowing rate, we would suggest that it form part of the Post Implementation Review (PIR) of IFRS 16. However, we have no evidence at this stage that it should, given that 2019 is the first year of IFRS 16's application. We also note that the Board's process for PIRs is thorough in identifying topics for its consideration.

### **Clarifications to the wording of the tentative agenda decision**

#### *Respondents' comments*

36. Two respondents (the ASCG and KPMG) agree with the Committee's analysis and conclusion, but recommend specific amendments to the following paragraph of the tentative agenda decision:

The definition of a lessee's incremental borrowing rate in IFRS 16 does not explicitly require a lessee to determine its incremental borrowing rate to reflect the interest rate in a loan with a similar payment profile to the lease payments. Nonetheless, the Committee observed that, in applying judgement in determining its incremental borrowing rate as defined in IFRS 16, a lessee might often refer as a starting point to a readily observable rate for a loan with a similar payment profile to that of the lease.

37. The ASCG suggests removing the word 'explicitly' in the first sentence. This is because it found the tentative agenda decision unclear as to whether reflection of the payment profile is *implicitly* required.

38. KPMG expressed concerns that the tentative agenda decision could be interpreted to suggest that a lessee has a wholly free choice regarding the payment profile, as well as by extension other factors, in determining its incremental borrowing rate.
39. Consequently, KPMG suggests the following change to the wording of the tentative agenda decision:

‘The definition of a lessee’s incremental borrowing rate in IFRS 16 does not explicitly require a lessee to determine its incremental borrowing rate to reflect the interest rate in a loan with a similar payment profile to the lease payments. ~~Nonetheless~~However, the Committee observed that, in applying judgement in determining its incremental borrowing rate as defined in IFRS 16, it would be consistent with the Board’s objective when developing the definition of incremental borrowing rate for a lessee to ~~might often~~ refer as a starting point to a readily observable rate for a loan with a similar payment profile to that of the lease.’

*Staff analysis*

40. The wording suggestions made by the ASCG and KPMG are related, but opposite in terms of practical outcomes. Removing the word ‘explicitly’ from the tentative agenda decision (as suggested by the ASCG) would increase the likelihood of a lessee thinking it has free choice in considering the payment profile in its determination of incremental borrowing rate. The statement in the tentative agenda decision is accurate and, in our view, removing ‘explicitly’ would not improve it.
41. As described in our initial consideration ([June 2019 Agenda Paper 2](#)), the Board’s intention when developing the definition of a lessee’s incremental borrowing rate was for a lessee to start with the best information it has available and adjust accordingly. *If* a readily observable amortising loan rate is available to the lessee in relation to a lease with payments over time, we would expect the lessee to use that rate as a starting point. Nevertheless, we continue to agree with the Committee’s conclusion

that IFRS 16 does not *require* a lessee's incremental borrowing rate to reflect the payment profile in every case.

42. We think the change to the wording suggested by KPMG does reflect the Board's intent, however we think it does not change the meaning of the tentative agenda decision in any practical way.
43. On balance, therefore, we recommend that the Committee does not amend the tentative agenda decision as suggested by either the ASCG or KPMG.

### **Staff recommendation**

44. On the basis of our analysis, we recommend finalising the agenda decision as published in [IFRIC Update](#) in June 2019. Appendix A to this paper sets out the proposed wording of the final agenda decision.

#### **Question for the Committee**

Does the Committee agree with our recommendation to finalise the agenda decision set out in Appendix A to this paper?

## Appendix A—Proposed wording of the agenda decision

A1. We propose the following wording for the final agenda decision, which is unchanged from the tentative agenda decision except to remove the square brackets in the last paragraph.

### **Lessee's Incremental Borrowing Rate (IFRS 16 Leases)**

The Committee received a request about the definition of a lessee's incremental borrowing rate in IFRS 16. The request asked whether a lessee's incremental borrowing rate is required to reflect the interest rate in a loan with both a similar maturity to the lease and a similar payment profile to the lease payments.

Applying IFRS 16, a lessee uses its incremental borrowing rate in measuring a lease liability when the interest rate implicit in the lease cannot be readily determined (paragraph 26 of IFRS 16). Appendix A to IFRS 16 defines a lessee's incremental borrowing rate 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 lessee's incremental borrowing rate is therefore a lease-specific rate that the Board defined 'to take into account the terms and conditions of the lease' (paragraph BC162).

In determining its incremental borrowing rate, the Board explained in paragraph BC162 that, depending on the nature of the underlying asset and the terms and conditions of the lease, a lessee may be able to refer to a rate that is readily observable as a starting point. A lessee would then adjust such an observable rate as is needed to determine its incremental borrowing rate as defined in IFRS 16.

The Committee observed that the definition of a lessee's incremental borrowing rate requires a lessee to determine its incremental borrowing rate for a particular lease considering the terms and conditions of the lease, and determine a rate that reflects the rate it would have to pay to borrow:

- (a) over a similar term to the lease term;
- (b) with a similar security to the security (collateral) in the lease;

(c) the amount needed to obtain an asset of a similar value to the right-of-use asset arising from the lease; and

(d) in a similar economic environment to that of the lease.

The definition of a lessee's incremental borrowing rate in IFRS 16 does not explicitly require a lessee to determine its incremental borrowing rate to reflect the interest rate in a loan with a similar payment profile to the lease payments. Nonetheless, the Committee observed that, in applying judgement in determining its incremental borrowing rate as defined in IFRS 16, a lessee might often refer as a starting point to a readily observable rate for a loan with a similar payment profile to that of the lease.

The Committee concluded that the principles and requirements in IFRS 16 provide an adequate basis for a lessee to determine its incremental borrowing rate. Consequently, the Committee ~~decided~~ not to add the matter to its standard-setting agenda.

## Appendix B: Analysis of other comments

B1. The table below outlines other comments, together with our analysis and conclusions.

Respondents' comments	Staff analysis and conclusions
<p><i>1. Availability of readily observable interest rates</i></p> <p>Two respondents (Mazars and Deloitte) say the Committee has ignored in its analysis that readily observable interest rates are often available only for loans with a final bullet payment and not for amortising loans. These respondents are concerned that a lack of observable data will lead entities to default to using the interest rate for a bullet repayment loan.</p>	<p><i>We recommend no action in response to this matter</i></p> <p>We think the matter raised by Mazars and Deloitte is not a technical matter. As described in paragraph 41 of this paper, if a readily available rate for a relevant amortising loan exists, we would expect an entity to use that rate as a starting point. However, the prevalence of such rates does not affect the Committee's conclusion regarding the application of the requirements in IFRS 16.</p>
<p><i>2. Request for additional explanation / educational material</i></p> <p>The KASB has requested educational material to address questions that arise in practice on the incremental borrowing rate, which include:</p> <p>a. the meaning of 'similar security'; and</p>	<p><i>We recommend no action in response to this matter.</i></p> <p>We think respondents' requests for educational material/additional explanatory material goes beyond the scope of the submission received by the Committee. Consequently, we recommend that the Committee does not take any action in response to these requests.</p>

<b>Respondents' comments</b>	<b>Staff analysis and conclusions</b>
<p>b. how to calculate the value of the right-of-use asset before a discount rate is determined.</p> <p>David Hardidge also suggested the inclusion of additional explanatory material to address practice questions. He provided the following examples:</p> <p>a. a lease ‘borrowing’ secured 100% against the associated asset, but regular borrowings have lower loan to value ratios; and</p> <p>b. a lease rental that is fixed will have different risk characteristics to a lease with CPI increases.</p>	<p>We note that the Board previously developed educational material about a lessee’s incremental borrowing rate that is available on the IFRS Foundation public <a href="#">website</a>.</p>
<p><i>3. US GAAP</i></p> <p>ESMA is concerned that the tentative agenda decision might introduce divergence between IFRS and US GAAP on a part of IFRS 16 that was previously considered to be converged.</p>	<p><i>We recommend no action in response to this matter.</i></p> <p>The Committee’s role is to discuss the application of requirements in IFRS Standards. The Committee has no remit to comment on requirements in US GAAP.</p>