Principles for determining lease discount rate

Do lessees need to determine a discount rate for every lease?

Yes, a lessee will need to determine a discount rate for each lease to which it applies the new lessee accounting model under SB-FRS 116, except in the following circumstances:

i. If the lease is fully prepaid, such that there are no future lease payments to discount e.g. real estate leases in which lessee obtains right to use real estate in exchange for a single upfront lease payment.
ii. If payments made to the lessor are all variable and depend on sales or usage. In this case, lessee will recognise variable lease payments as an expense as they are incurred e.g. leases of electricity generating assets such as solar plants or wind farms, in which lease payments depend on amount of electricity generated.
iii. If lessee applies recognition exemptions to the leases i.e. exemption for short-term leases and leases of underlying assets that are of low value. In this case, lessee generally recognises lease expense on straight-line basis.
iv. If lessee uses a portfolio approach and determines a single discount rate for a portfolio of leases with similar characteristics. This is permitted if the Statutory Board expects that this approach would not differ materially from applying the Standard to its individual leases.

Should lessees use interest rate implicit in the lease or lessee's incremental borrowing rate?

The interest rate implicit in the lease is the discount rate at which the sum of the present value of (i) lease payments and (ii) unguaranteed residual value equals the sum of the (i) fair value of underlying asset and (ii) any initial direct costs of the lessor.

In principle, a lessee should discount lease payments using interest rate implicit in the lease if this can be readily determined. Otherwise, a lessee uses its incremental borrowing rate.

However, in practice, a lessee will often struggle to determine the interest rate implicit in the lease for the following reasons:

i. The interest rate implicit in the lease is a *lessor-specific measure*. In general, the lessee will not know the absolute amount of costs incurred by the lessor in negotiating the lease or whether a given cost would qualify to be an initial direct cost.
ii. The interest rate implicit in the lease depends on the initial fair value of the underlying asset, and the lessor's expectation of the residual value of the asset at the end of the lease term. A lessee will usually not have the information to determine both of these amounts unless the underlying asset is acquired by the lessor at lease inception and the residual value of the asset will be conveyed to the lessee at the end of the lease term i.e. the lease includes an automatic transfer of title or bargain purchase option.
iii. The interest rate implicit in the lease is likely to be a commercially sensitive figure to the lessor. Thus, lessors will generally not wish to disclose it, or will otherwise prefer to disclose

only general information about their pricing arrangements. Even if a lessor does disclose relatively specific pricing information to a lessee, lessees should exercise appropriate professional skepticism when evaluating this information. In practice, due diligence procedures may be required before a lessee can determine a discount rate based on information provided by a lessor.

Therefore, the lack of information available to the lessee on the interest rate implicit in the lease will typically make it difficult for the lessee to determine this rate. Thus, we expect that lessees will usually use their incremental borrowing rate.

<u>What is the difference between the two discount rates?</u>

Interest rate implicit in lease	**Lessee's incremental borrowing rate**
A measure of the minimum return that lessor expects to earn on the lease	Rate that lessee would expect to borrow over a similar term and with a similar security on the right-of-use asset
Specific to lessor	Specific to lessee

<u>What are the factors that affect incremental borrowing rate?</u>

A lessee's incremental borrowing rate is affected by the following factors:

i. The credit risk of the lessee;
ii. The term of the lease;
iii. The nature and quality of the underlying asset i.e. the 'security';
iv. The amount 'borrowed' by the lessee; and
v. The economic environment (the country, the currency and the date that the lease is entered into) in which the transaction occurs.

The impact of the above facotrs on the incremental borrowing rate is generally as follows:

Factor	**Increase/Decrease**	**Impact on incremental borrowing rate**
Credit risk of lessee	Increase	Increase
	Decrease	Decrease
Borrowing term	Increase	Increase
	Decrease	Decrease
Quality of security	Increase	Decrease
	Decrease	Increase
Amount of funds borrowed	Increase	Increase
	Decrease	Decrease

<u>How should Statutory Boards who are lessees determine the incremental borrowing rate, given that there are some Statutory Boards which do not have external borrowings?</u>

Some Statutory Boards which do not borrow externally to finance their expenditure use the cost of equity for public agencies for the financial year as a proxy for the incremental borrowing rate.

For Statutory Board which partially finances its expenditure through external borrowings, they have used some of the following rates as proxies to determine incremental borrowing rate:

- Singapore Government Securities (SGS) rate of a similar tenure as the relevant lease;
- Statutory Board-issued bond rate of a similar tenure as the relevant lease; or
- General borrowing rate from banks. This rate is entity-specific (e.g. it includes the Statutory Board's credit rating) but does not consider features specific to the lease (e.g. lease term).

There is no need for consistency in the type of reference rate used across Statutory Boards to determine the incremental borrowing rate, because SB-FRS 116 requires such incremental borrowing rate to be *entity-specific* and *lease-specific*.

For all of the above proposed rates, adjustments will required to determine the Statutory Board's incremental borrowing rate for each lease e.g. adjustments for the lease term, the nature and quality of the underlying asset, date at which the lease is entered into.

For example, if a Statutory Board is a lessee and enters into a building lease and an equipment lease, and the Statutory Board uses its general borrowing rate as a reference rate, it will need to consider the following factors in making the relevant adjustments to arrive at its incremental borrowing rate:

Factors	**Building lease**	**Equipment lease**
Term of lease	10 years	5 years
Amount of funds 'borrowed'	1,000,000	10,000
Nature and quality of underlying asset i.e. the 'security'	Building	Equipment
Economic environment i.e. date at which lease is entered into, currency of lease etc.	Lease entered into on 1 April 2019	Lease entered into on 1 April 2020

As both leases have different characteristics, it is highly likely that the Statutory Board will conclude that it has a different incremental borrowing rate for each lease.

However, as a practical expedient, the Statutory Board may determine a single discount rate for a portfolio of leases with similar characteristics.

For example, if a Statutory Board is a lessee and has multiple types of leases with different classes of underlying assets e.g. aircraft, property and motor vehicles, the Statutory Board may consider using the practical expedient as follows:

Types of leases	**Practical expedient considered on a lease-by-lease basis**

Motor vehicles	Statutory Board may determine that the motor vehicle leases entered into at the same time and for a similar term have similar characteristics, allowing it to apply a single discount rate to those leases.
Aircraft	Statutory Board may determine that its aircraft and properties have different characteristics and terms, therefore requiring different discount rates to be determined for each individual aircraft and property.
Property	

<u>When should a lessee revise the lease discount rate?</u>

A lessee is required to determine a new or revised discount rate *each time a lease is modified*.

There are essentially two possible scenarios arising from a lease modification:

Modification	**Impact**
Modification not accounted for as separate lease	The lessee remeasures the lease liability using a revised discount rate. The revised rate is determined at the effective date of the modification (i.e. date when both parties agree to the modification). Similar to the determination of a discount rate at lease commencement, the lessee uses a revised interest rate implicit in the lease if it is readily determinable, or a revised incremental borrowing rate if it is not.
Modification accounted for as separate lease	The lessee does not revise the discount rate for the original lease. However, lessee is required to determine a discount rate for the modification itself, which is accounted for as a separate lease.