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Ms. Susan M. Cosper
Technical Director
Financial Accounting Standards Board
401 Merritt 7
P.O. Box 5116
Norwalk, CT 06856-5116

Re: FASB Agenda Request – Determining a lessee's discount rate: when use of the rate implicit in a lease is required

Dear Ms. Cosper:

Deloitte & Touche LLP appreciates the opportunity to provide an agenda request to the FASB. We request that the FASB consider an agenda topic to provide additional or amended guidance in ASC 842, *Leases*, regarding when the lessee should apply the rate implicit in a lease as its discount rate. Determining the discount rate for a lease is an essential component of implementing and applying ASC 842, because the discount rate will have a direct impact on the measurement of right-of-use assets and lease liabilities recorded by a lessee.

ASC 842 defines the discount rate to be used by a lessee as the rate implicit in the lease unless that rate cannot be *readily determined*, then the lessee is required to use its incremental borrowing rate. We believe that constituents are having a difficult time interpreting what was intended in the standard's use of the threshold of being "readily determined" and this has led to diversity in views. For example, some constituents believe that the implicit rate is readily determinable only when the lessee knows the exact rate or the exact inputs into the rate calculation that the lessor used. Other constituents believe the implicit rate is also readily determinable when there is information publicly available to the lessee for all significant inputs in the calculation of the implicit rate and it would be reasonable to expect the lessor would have used these inputs such that the lessee can reliably estimate the rate implicit in the lease.

This issue matters because often the incremental borrowing rate and implicit rate in the lease are significantly different. While the two proposed Accounting Standards Updates (2010 and 2013) leading up to Accounting Standards Update 2016-12 indicated in the basis for conclusions that "[i]n theory, the rate implicit in the lease should equal the lessee's incremental borrowing rate" we have found in practice this is not true and believe the theory is not generally accepted for various reasons.

How an entity interprets "readily determined" also affects the complexity in implementing the standard. The standard requires the implicit rate to be used unless it cannot be readily determined. Thus, before defaulting to determining its incremental borrowing rate, a less must first determine that the implicit rate or its significant inputs are not readily determinable. Depending on how broad to interpret whether inputs are readily determinable, exploring whether this information is readily determinable can require significant effort. Thus, another consideration may be to amend the guidance in ASC 842 to make implementation with respect to determination of the discount rate by the lessee simpler.

The Appendix to this letter contains a summary of the background of the issues and possible solutions for the Board to consider in enhancing the guidance in ASC 842. As this is a narrow issue that can be resolved in a short period of time, it may best be addressed by the EITF.

We would be happy to share additional perspectives and suggestions with the Board and FASB staff on the matter discussed in our agenda request. If you have any questions concerning this request, please contact Brandon Coleman at 312-486-0259 or Bob Uhl at 203-761-3152.

Yours truly,

Deloitte & Touche LLP

cc: James Barker

Appendix
Deloitte & Touche LLP
Agenda request – Lessee Discount Rate for a Lease

Authoritative Guidance

The following authoritative guidance in ASC 842-20-30 is referenced in this Appendix:

30-1 At the commencement date, a lessee shall measure both of the following:

a. The lease liability at the present value of the lease payments not yet paid, discounted using the discount rate for the lease at lease commencement (as described in paragraphs 842-20-30-2 through 30-4)

b. The right-of-use asset as described in paragraph 842-20-30-5.

30-2 The discount rate for the lease initially used to determine the present value of the lease payments for a lessee is calculated on the basis of information available at the commencement date.

30-3 A lessee should use the rate implicit in the lease whenever that rate is readily determinable. If the rate implicit in the lease is not readily determinable, a lessee uses its incremental borrowing rate. A lessee that is not a public business entity is permitted to use a risk-free discount rate for the lease, determined using a period comparable with that of the lease term, as an accounting policy election for all leases.

Additionally, the following definitions in the ASC Master Glossary are referenced:

Discount Rate for the Lease - 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.

Rate Implicit in the Lease - The rate of interest that, at a given date, causes the aggregate present value of (a) the lease payments and (b) the amount that a lessor expects to derive from the underlying asset following the end of the lease term to equal the sum of (1) the fair value of the underlying asset minus any related investment tax credit retained and expected to be realized by the lessor and (2) any deferred initial direct costs of the lessor.

Incremental Borrowing Rate - 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.

Lessee's Determination of the Discount Rate for the Lease

The definition of discount rate in ASC 842 clearly articulates that a lessee's discount rate should be the rate implicit in the lease unless it cannot be readily determined. That is, the rate implicit in the lease is given preference over the incremental borrowing rate. The preference in the standard towards the rate implicit in the lease is logical as it is specific to the commercial economics of the underlying lease transaction whereas, the lessee's incremental borrowing rate, while bearing some relationship to the lease is not as specific.

In developing ASU 2016-02, stakeholders appeared to agree with the preference. As described in paragraph BC199 of the Basis for Conclusions of ASU 2016-02 (**emphasis** added):

> There was broad support among those stakeholders that provided feedback on the discount rate for a lessee to use its incremental borrowing rate **in the absence of information about the rate the lessor charges the lessee**. Stakeholders also generally supported this approach because it is similar to the discount rate requirements for capital leases in previous GAAP.

As demonstrated in the basis for conclusions, a lessee should use its incremental borrowing rate only in the "absence of information" about the rate the lessor charges the lessee.

Thus, because of the preference for using the implicit rate, there is pressure on determining whether that rate is readily determinable.

Overview of Issue

In accordance with the guidance above, we have observed in practice that lessees have determined it unclear when a lessee should consider that the rate implicit in the lease can be "readily determined".

Part of the issue may stem from historical practice under ASC 840. The former standard for leases also used similar terms as it discussed an interest rate implicit in the lease and incremental borrowing rate. In applying ASC 840, lessees often defaulted to the use of the incremental borrowing rate. This default position was generally supportable because under ASC 840-10-25-31, the lessee must use its incremental borrowing rate unless (1) it is "practicable for the lessee to learn the implicit rate computed by the lessor", and (2) the implicit rate computed by the lessor is lower than the lessee's incremental borrowing rate. ASC 842 removed the requirement that the rate implicit in the lease may only be used if it is lower than the lessee's incremental borrowing rate (while giving priority to the rate implicit in the lease). Constituents are not clear on whether readily determinable in ASC 842 is the same as it being practicable for the lessee to learn the implicit rate computed by the lessor.

Issue: When is the rate implicit in the lease considered to be readily determined and thus, must be used by the lessee?

The following two views that have emerged in practice as an appropriate interpretation.

View A – "Readily determined" requires the rate or all inputs necessary to compute the rate to be received directly from the lessor

This interpretation is that the rate implicit in the lease should only be used by the lessee if the terms of the lease provides all inputs (e.g., certain synthetic leases), the lessor explicitly discloses the rate, or if the information the lessor used to determine the rate is otherwise made available by the lessor.

The definition of the rate implicit in the lease is focused on a lessor's inputs and assumptions. The components include, in part (**emphasis** added), "the amount that a **lessor expects to derive** from the underlying asset following the end of the lease term." This could be interpreted to mean that the lessee must know the lessor-specific assumptions. In addition, the initial direct costs, and in some cases investment tax credits, are lessor-specific and will generally not be known with precision by the lessee unless informed by the lessor. As such, proponents of this view believe these definitions are intended to state that the rate implicit in the lease can only be used by the lessee if the lessor explicitly discloses the rate or all the inputs.

Although "readily determined" is not defined in ASC 842, the term "readily determinable fair value" is defined in the ASC Master Glossary specific to the application of determining whether an equity security is within the scope of ASC 320, *Investments—Debt and Equity Securities*. The ASC Master Glossary defines "readily determinable fair value" as follows:

> An equity security has a readily determinable fair value if it meets any of the following conditions:
>
> a. The fair value of an equity security is readily determinable if sales prices or bid-and-asked quotations are currently available on a securities exchange registered with the U.S. Securities and Exchange Commission (SEC) or in the over-the-counter market, provided that those prices or quotations for the over-the-counter market are publicly reported by the National Association of Securities Dealers Automated Quotations systems or by OTC Markets Group Inc. Registered stock meets that definition if the restriction terminates within one year.
>
> b. The fair value of an equity security traded only in a foreign market is readily determinable if that foreign market is of a breadth and scope comparable to one of the U.S. markets referred to above.
>
> c. The fair value of an equity security that is an investment in a mutual fund or in a structure similar to a mutual fund (that is, a limited partnership or a venture capital entity) is readily determine if the fair value per share (unit) is determined and published and is the basis for current transactions.

View A proponents believe that the estimation methodology suggested in View B would not meet the threshold of "readily determinable fair value." Rather, the valuation techniques would result in classification of the leased asset (if it were a security) as a Level 2 or 3 measurement under ASC 820. That is, the valuation techniques described would not meet the threshold of a "readily determinable fair value". Opponents to View A note that a lease would never meet this valuation technique, because even if a lessor disclosed its rate to the lessee, it inherently would be based on the lessor's own Level 3 inputs.

View B – The rate implicit in the lease is "readily determined" when the rate or all inputs in the computation of the rate are received directly from the lessor (same as View A) ***or*** *the lessee can reliably estimate the rate from information publicly available to the lessee for all significant inputs in the calculation of the implicit rate and it would be reasonable to expect the lessor would have used such amounts.*

View B proponents believe that "readily determinable" in this context should be interpreted as the threshold can be met if the significant inputs can be reliably estimated based on public information. They do not believe the exact rate the lessor used or the exact amount for significant inputs the lessor used in computing the rate need to be learned from the lessor for the lessee to use the implicit rate.

The rate implicit in the lease can be considered "readily determined" when all of the significant inputs used to calculate the rate are readily determinable. That is, when the lessee can readily determine the fair value of the underlying asset, the amount the lessor expects to derive from the underlying asset at the end of the lease term, and the lessor's initial direct costs, provided that each of these has a material effect on the rate. Under this view, the significant inputs would be considered readily determinable when they can be reliably estimated from public information and it is reasonable to expect that the lessor would have used such amounts. In contrast, the rate implicit in the lease would not be considered readily determinable when any of the material inputs are not readily determinable.

Further, in scenarios in which material inputs are deemed "readily determinable" but immaterial inputs are not, it may be reasonable for a lessee to estimate those inputs when determining the rate implicit in the lease if such inputs are not expected to materially affect the resulting calculations (e.g., when the lessee does not know the lessor's initial direct costs but the lack of precision in an estimate of a reasonable amount of initial direct costs would not have a meaningful impact on the calculated rate).

In summary, View B proponents acknowledge that a reliable estimate is a high threshold; however, that high threshold should not be interpreted to mean that the rate implicit in the lease must be received directly from the lessor. Such an interpretation, from the perspective of View B proponents, is contrary to the preference provided to the rate implicit in the lease.

View B proponents consider each of the inputs utilized in the calculation of the rate implicit in the lease and the ability for a lessee to obtain reliable information for such input:

- Lease payments: The lease payments are contractually determined and do not require any estimation.

- Fair value of the underlying asset: The fair value of the underlying asset at lease commencement (or in the case of transition, as of the effective date of ASC 842) for many asset classes can be established in an informed and unbiased manner using valuation techniques consistent with those in ASC 820, *Fair Value Measurement*. This valuation would replicate the same analysis a prudent lessor would undertake in determining the rate implicit in the lease. That is, although the process is inherently an estimate, View B proponents believe that it is possible for such estimation to meet the threshold of "readily determinable" because it reflects the same fair value that a lessor would determine within a reasonable range.

- Future residual value of the underlying asset: The valuation of the forecasted future residual value at the end of the lease term for many asset classes can be performed in an informed and unbiased manner utilizing ASC 820 valuation approaches and information from public sources. For example, there are valuation specialists that publish estimates of forecasted future residual values for many asset classes (e.g., automobiles, airplanes, etc.) and this information is often used by lessors. Similar to determining the fair value of the underlying asset component of the rate implicit in the lease, a lessee can reliably estimate a residual value that is materially consistent with what the lessor would calculate (i.e., "the amount that a lessor expects to derive from the underlying asset…" as included in the above definition).

- Deferred initial direct costs: The lessor's deferred initial direct costs (as defined in ASC 842-10-20) at lease commencement (or in the case of transition, as of the effective date of ASC 842) although many times not known for each lease, can be estimated based on experience with other similar leases. Alternatively, variations in initial direct costs, would rarely have a material impact on the rate implicit in the lease. Therefore, although this estimation may not meet a threshold of "readily determined," the absence of readily determinable support for immaterial inputs may not impact the use of the rate implicit in the lease.

- Investment tax credits: The lessee will typically have knowledge of any tax credits available in a particular market, which would be included in the calculation, if material.

While a lessee's estimate and a lessor's computation of the implicit rate may not be identical, View B proponents would not expect the differences to be any greater than if two different prudent lessors made the same estimates and calculations for the same property, both of which would be expected to result in an appropriate rate implicit in the lease to the lessor. Therefore, this view asserts that lessees can establish an acceptable approach to determine the material components of the rate implicit in the lease in a manner similar to a prudent lessor.

In both Exposure Drafts (2010 and 2013) on this topic, the basis for conclusion, in the section on the discount rate, specifically noted that lessee and lessor could have different estimates of the rate implicit in the lease. The basis for conclusion further stated that the Board agreed with respondents that the rate implicit in the lease could be readily determined in some circumstances implying that the rate could be the lessee's estimate. While this discussion was not repeated in the basis for conclusion in the final ASU the proposed provision regarding the discount rate were carried forward into the final ASU.

This view can further be supported by the fact that both the rate implicit in the lease and a lessee's incremental borrowing rate require a degree of estimation. Determining the rate implicit in the lease requires assumptions and estimates on the part of the lessee. Similarly, determining the incremental borrowing rate often requires significant reliance on assumptions and a determination of the lessee's incremental borrowing rate at the commencement date of a lease may be difficult. For example, if a lessee did not incur borrowings at or near the commencement date of a lease that were for a term similar to the lease term, the lessee may need to determine its incremental borrowing rate through discussions with bankers or other lenders, or by reference to obligations of a similar term issued by others with a credit rating similar to that of the lessee. Determining the incremental borrowing rate would also be challenging in situations where the lessee is a subsidiary of a public company and does not have any external borrowings. Therefore, because lessees would be required to employ a certain level of estimation in determining its incremental borrowing rate, View B proponents believe that it should also be allowed a certain level of estimation in the determination of the rate implicit in the lease. They also believe that this estimate of the rate implicit in the lease is more representationally faithful to the economics of the specific lease than the lessee's estimation of its incremental borrowing rate.

Alternative Approach to the Issue

Some proponents of View B believe that an estimation by the lessee of the rate implicit in the lease is preferable to use of the lessee's incremental borrowing rate, but are concerned that requiring all lessees to determine whether sufficient information exists creates an unnecessary burden. Proponents of this view believe a better approach would be to amend ASC 842 to remove the "readily determined" standard. Instead, some proponents support an alternative model in which the rate implicit in the lease must be used if the rate the lessor used or all the inputs that the lessor used in computing the rate are received from the lessor. However, if the rate or information is not received from the lessor, proponents believe the lessee should use an estimate of the rate implicit in the lease if it is reliably estimable but can choose as a practical expedient (consistently chosen for all leases for the same type of underlying asset) to use the lessee's incremental borrowing rate. If the rate implicit in the lease cannot be reliably estimated, the lessee's incremental borrowing rate must be used.

Supporters of this recommendation believe it has the following benefits:

1. Eliminates having to interpret the unclear term "readily determined".

2. It makes clear that the rate implicit in the lease is more accessible to lessees and is a better reflection of the negotiated economics of the lease transaction.

3. Does not impact lessees who wish to continue applying the incremental borrowing rate as a practical expedient as exploring whether all the inputs needed in computing the implicit rate are available and can be reliably estimated could be unnecessarily burdensome.

This proposed amendment is just one of a number of potential proposals. If the standard setter believes that an amendment is warranted to reduce unnecessary complexity, different models could be considered.

Some may observe that an amendment, such as the one proposed above, could create less comparability in discount rates. However, due to the existing diverse applications of the incremental borrowing rate (including the flexibility in collateral used in the hypothetical borrowing), comparability issues may already exist. Some also may observe that an amendment could create further divergence in the discount rate definition compared to the guidance in IFRS 16, *Leases* (note that some believe that diversity is also beginning to develop around the interpretation of "readily determined" under IFRS 16). However, the US GAAP and IFRS definitions are already not completely aligned.

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