



Leases Discount rates

What's the correct rate?

IFRS 16

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Determining the correct rate

IFRS 16 *Leases* requires lessees to bring most leases onto the balance sheet. The new assets and liabilities are initially measured at the present value of the lease payments. But discounted at what rate?

This question will be at the heart of many transition projects particularly for lessees. The discount rate affects the amount of the lessee's lease liabilities – and a host of key financial ratios.

The new standard brings forward definitions of discount rates from the current leases standard. But applying these old definitions in the new world of on-balance sheet lease accounting will be tough, especially for lessees. They now need to determine discount rates for most leases previously classified as operating leases.

Determining the appropriate discount rate will be particularly demanding at transition. Identifying appropriate discount rates and documenting the basis for these determinations will be a major task – particularly for a company brave enough to adopt the new standard retrospectively.

This publication provides an overview of how to determine the appropriate discount rate and how this will affect your financial statements. We hope it will help you as you prepare to adopt the new standard.

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1

At a glance

Determining the appropriate discount rate is a key area of judgement.

1.1

Key facts

Lessors

IFRS 16.63(d), 68

A lessor uses the interest rate implicit in the lease for the purposes of lease classification and to measure the net investment in a finance lease.

IFRS 16.A

The interest rate 'implicit' in the lease is the discount rate at which:

- the sum of the present value of (i) the lease payments and (ii) the unguaranteed residual value *equals*
- the sum of (i) the fair value of the underlying asset and (ii) any initial direct costs of the lessor.

Lessees

IFRS 16.26

A lessee discounts the lease payments using the interest rate implicit in the lease if this can be readily determined. Otherwise, the lessee uses its incremental borrowing rate.

IFRS 16.A

The lessee's 'incremental borrowing rate' is 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.

IFRS 16.BC161

That is, the lessee's incremental borrowing rate is specific to:

- the lessee: it is a company-specific rate;
- the term of the arrangement: this will typically be the lease term, unless the lease payments are paid up-front;
- the amount of the funds 'borrowed';
- the 'security' granted to the lessor: i.e. the nature and quality of the underlying asset; and
- the economic environment: i.e. the jurisdiction and the time at which the lease is entered into, and the currency in which the lease payments are denominated.

IFRS 16.5

A lessee is required to identify a discount rate for all leases other than those for which it elects to apply the recognition exemptions for short-term leases and leases in which the underlying item is of low value.

1.2

Key impacts

Increased focus on determining the appropriate discount rate. Lessees will need to identify discount rates for most leases, including those previously classified as operating leases under IAS 17 *Leases*. The exceptions are leases for which the lessee applies the recognition exemptions.

Many lessee financial ratios will be sensitive to the discount rate. While not a free choice, using a higher discount rate will reduce reported liabilities, but other financial ratios will also be affected.

Ratio	Impact of a higher discount rate for a given lease	
Gearing/leverage		Lower, due to lower lease liabilities
Asset turnover		Higher, because the right-of-use asset and therefore total assets will be lower
Current ratio		Higher, because the current portion of the lease liability will be lower
Operating profit/earnings before interest and tax (EBIT)		Higher, because depreciation will be lower
Earnings before interest, tax, depreciation and amortisation (EBITDA)		Unchanged, because depreciation and interest are both excluded in calculating EBITDA
Interest cover		Lower, because interest expense will be higher

For a single lease, a higher discount rate will accentuate the front-loading of total lease expense impacting, for example, the profile of profit before tax (PBT) and earnings per share (EPS) over the lease term. This is because a higher discount rate reduces total depreciation expense (typically recognised on a straight-line basis) and increases total interest expense (recognised on a front-loaded basis).

New systems and processes. Systems and process changes may be required to capture and assess the data necessary to comply with the new requirements. New calculations and review processes will be needed to determine the discount rate.

Estimates may need to be revised. A lessee will determine a discount rate on lease commencement and may be required to revise it – e.g. if the lease is modified. This will require ongoing monitoring and increase accounting volatility.

Choice of transition approach will be key. The extent of discount rate information required in 2019 will depend on the transition approach chosen – e.g. under a retrospective approach, historical discount rates must be determined.

Sufficient documentation. The judgements and assumptions applied in determining the appropriate discount rate will need to be documented.

2

Lessor discount rate

Key judgemental issues for lessors under the new standard are brought forward from the current standard.

2.1

IFRS 16.63(d), 68

Rate implicit in the lease

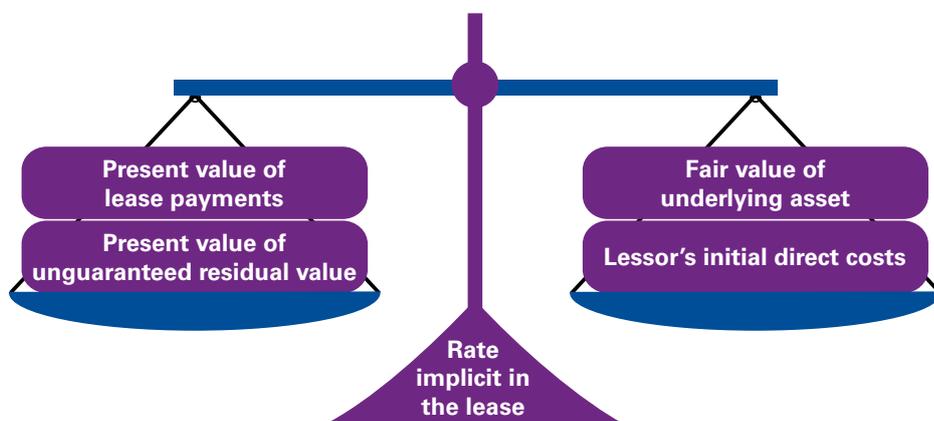
A lessor uses the interest rate implicit in the lease to:

- calculate whether the present value of the lease payments amounts to at least substantially all of the fair value of the underlying asset when assessing lease classification at inception; and
- measure the net investment in the lease at commencement for leases classified as finance leases.

IFRS 16.A

The interest rate implicit in the lease is the discount rate at which:

- the sum of the present value of (i) the lease payments and (ii) the unguaranteed residual value *equals*
- the sum of (i) the fair value of the underlying asset and (ii) any initial direct costs of the lessor.



Example 1 – Interest rate implicit in the lease

Lessor B enters into a lease of a motor vehicle. The lease term is five years. The fair value of the motor vehicle is 10,000 and B expects that its fair value at the end of the lease (i.e. the unguaranteed residual value) will be 1,000. Lease rentals are 2,000 per annum, payable in arrears. B incurs initial direct costs of 500.

B calculates the interest rate implicit in the lease as follows.

Lease inception (outflows of 10,000 + 500)	(10,500)
Year 1 (inflow of 2,000)	2,000
Year 2 (inflow of 2,000)	2,000
Year 3 (inflow of 2,000)	2,000
Year 4 (inflow of 2,000)	2,000
Year 5 (inflows of 2,000 + 1,000)	3,000

B therefore calculates the interest rate implicit in the lease as the rate that sets the discounted inflows in Years 1–5 equal to the outflow at inception – i.e. the internal rate of return of the above flows. In this case, that rate is 1.48%.



Is the new standard's guidance on lessor discount rates similar to that under the current standard?

Yes – much of the new standard's guidance on lessor accounting is brought forward unamended from IAS 17 and many lessors will encounter no 'new' recognition and measurement issues when applying the new standard.

However, there are areas in which lessor accounting relies on the more specific definitions and/or more detailed requirements introduced by the new standard – e.g. relating to sub-leases and sale-and-leaseback transactions.



Does a lessor need to determine a discount rate for all leases?

No – at least not for accounting purposes.

A lessor may need to determine a discount rate for two reasons, but neither applies to all leases.

First, a lessor may need the discount rate to calculate whether the present value of the lease payments amounts to at least substantially all of the fair value of the underlying asset when assessing lease classification.

IFRS 16.65

However, in many cases a lessor will not need to perform a present value calculation to determine lease classification. For example, in some cases if the undiscounted value of the lease payments is less than substantially all of the fair value of the underlying asset, then it is clear that any positive discount rate will increase the headroom on the test. This will be the case for many shorter leases. In other cases, the presence of a significant level of variable lease payments may make it clear that the lease is an operating lease. This may be the case for real estate leases in which rentals are periodically adjusted to market value, or are based on the sales that the lessee generates by trading at the property.

Second, a lessor will need a discount rate to account for a lease if the lease is classified as a finance lease – but not if it is classified as an operating lease. Further, there are no disclosure requirements for operating leases that require a lessor to determine the rate implicit in the lease.

2.2

Practical issues for lessors



Which costs qualify as 'initial direct costs' when determining the interest rate implicit in the lease?

IFRS 16.A

'Initial direct costs' are the costs of obtaining the lease that would not have been incurred if the lease had not been obtained.

This definition is similar to the definition of the incremental costs of obtaining a contract under IFRS 15 *Revenue from Contracts with Customers*. That is, the focus is on costs that are contingent on actually obtaining the lease – costs that are directly attributable to seeking to obtain a lease but are incurred irrespective of whether the lease is actually obtained are *not* initial direct costs.

✓ Include	✗ Exclude
<ul style="list-style-type: none"> – Commissions – Legal fees* – Costs of negotiating lease terms and conditions* – Costs of arranging collateral – Payments made to existing tenants to obtain the lease <p>* If they are contingent on origination of the lease</p>	<ul style="list-style-type: none"> – General overheads – Costs to obtain offers for potential leases

This means that the interest rate implicit in the lease is always a company-specific rate, not a market participant rate – i.e. it depends on the specific costs incurred by the lessor.

IFRS 16.A

 **Which lease payments are included when determining the interest rate implicit in the lease?**

A lessor does not include all of the payments that it expects the lessee to make when determining the interest rate implicit in the lease – it uses the ‘lease payments’ as defined in the new standard.

For a lessor, the lease payments are as follows.

 Include	 Exclude
<ul style="list-style-type: none"> – Fixed payments, less any lease incentives – In-substance fixed payments – Variable payments based on the current value of an index or rate – Exercise price of a purchase option that the lessee is reasonably certain to exercise – Termination penalty payable by the lessee consistent with assumption about the lease term – Residual value guarantees provided by any party capable of discharging their obligations under the guarantee 	<ul style="list-style-type: none"> – Variable payments based on sales or usage of the underlying asset – Variable payments based on future changes in an index or rate – Payments for non-lease components

Because a lessor uses the ‘lease payments’ defined in the new standard when determining the interest rate implicit in the lease, it excludes certain payments that the lessor expects to receive from the lessee – e.g. variable payments based on sales or usage of the underlying asset.

As a result, the interest rate implicit in the lease is not necessarily the return that the lessor expects to earn on the lease as a whole.

IFRS 16.63(d)

 **When does a lessor determine the interest rate implicit in the lease?**

Initially, a lessor determines the discount rate at lease inception – i.e. the date of the lease agreement or, if earlier, the date at which the parties commit to the principal terms and conditions of the lease. This is necessary so that the lessor can calculate whether the present value of the lease payments amounts to at least substantially all of the fair value of the underlying asset when assessing lease classification.

IFRS 16.77

IFRS 16.79, 87

**When does a lessor revise the interest rate implicit in a lease?**

Generally, a lessor does not revise the interest rate implicit in the lease after lease commencement. For example, if the lessor recognises an impairment of the net investment in the lease under IFRS 9 *Financial Instruments*, then it will subsequently account for the impaired balance using the original discount rate.

However, a lessor may be required to determine a new interest rate implicit in the lease when the terms and conditions of the lease change – i.e. when there is a lease modification. For example, if the modification is accounted for as a separate lease, then the lessor will determine the interest rate implicit in that new lease – see Section 4.3.

IFRS 16.B1

**Can a lessor use a portfolio approach to determine the interest rate implicit in a lease?**

Yes. The new standard permits a company – whether it is acting as a lessee or lessor – to apply the standard to a portfolio of leases with similar characteristics. This is permitted if the company expects that this approach would not differ materially from applying the new standard to individual leases.

**How does a lessor determine the interest rate implicit in a lease of land?**

This can be complex because land typically has an indefinite life, it generally does not depreciate in value – and often increases in value – and leases of land can be very long in practice. This is an example of a key judgement under both the current standard and the new standard – see Section 4.1.

3 Lessee discount rates

With lessees recognising leases on-balance sheet, the appropriate discount rate will affect the balance sheet and key ratios.

3.1 Implicit vs incremental borrowing rate

IFRS 16.26

A lessee discounts the lease payments using the interest rate implicit in the lease if this can be readily determined. Otherwise, the lessee uses its incremental borrowing rate.

The rate implicit in the lease,
if readily determinable

or

The lessee's incremental
borrowing rate



Does a lessee need to determine a discount rate for every lease?

Generally, yes – the lessee needs a discount rate for each lease to which it applies the new lessee accounting model. The lessee uses the discount rate to calculate the present value of the future lease payments.

The only exceptions are as follows.

- If the lease is fully prepaid, such that there are no future lease payments to discount, then the lessee will not need a discount rate. This may be the case in some real estate leases in which the lessee obtains the right to use the real estate in exchange for a single up-front lease payment.
- If the payments made to the lessor are all variable and depend on sales or usage, then the lessee will not need a discount rate. Instead, the lessee will recognise the variable lease payments as an expense as they are incurred. This may be the case in some leases of electricity generating assets such as solar plants or wind farms, in which the lease payments depend on the amount of electricity generated. It may also be the case for some leases of real estate in the retail sector, in which lease payments depend on the sales of the lessee.
- The lessee will not need a discount rate for leases to which it applies the recognition exemptions – i.e. the exemptions for short-term leases and leases of underlying assets that are of low value. In these cases, the lessee generally recognises lease expense on a straight-line basis, similar to current operating lease accounting.

In addition, a lessee may use a portfolio approach and determine a single discount rate for a portfolio of leases with similar characteristics. This is permitted if the company expects that this approach would not differ materially from applying the standard to individual leases.

IFRS 16.38(b)

IFRS 16.5

IFRS 16.B1

IFRS 16.A, BC160

**Are the interest rate implicit in the lease and the lessee's incremental borrowing rate just different ways of estimating the same thing?**

No, the two rates are conceptually different.

Interest rate implicit in the lease	Lessee's incremental borrowing rate
Essentially, a measure of the minimum return that the lessor expects to earn on the lease	Essentially, the rate that the lessee would expect to borrow at over a similar term and with a similar security on the right-of-use asset
Specific to the lessor	Specific to the lessee
See Chapter 2	See Section 3.3

**Will the interest rate implicit in the lease generally be higher or lower than the lessee's incremental borrowing rate?**

This will depend on the facts and circumstances of each lease, because both rates are company-specific.

However, for a given lease with fixed lease payments in which the lessee and the lessor have broadly similar credit ratings, the interest rate implicit in the lease will generally be higher than the lessee's incremental borrowing rate.

Put crudely, this is because the interest rate implicit in the lease reflects the estimated minimum return of the lessor including the unguaranteed residual value.

**What is the impact of the discount rate being higher or lower?**

The most obvious impact of the discount rate being higher or lower is that the initial measurement of the lease liability will be lower or higher. That is, if the same set of lease payments is discounted by a higher rate, then the resulting lease liability will be lower.

However, the financial statement impacts of having a higher or lower discount rate are more pervasive. For example, the discount rate will impact the allocation of total expense between depreciation and interest throughout the lease term – a higher discount rate will reduce depreciation and increase interest expense in each reporting period throughout the lease term.

The impact on a selection of common financial ratios of a higher discount rate is as follows.

Ratio	Impact of a higher discount rate for a given lease
Gearing/leverage	Lower, due to lower lease liabilities
Asset turnover	Higher, because the right-of-use asset and therefore total assets will be lower
Current ratio	Higher, because the current portion of the lease liability will be lower
Operating profit /EBIT	Higher, because depreciation will be lower
EBITDA	Unchanged, because depreciation and interest are both excluded in calculating EBITDA
Interest cover	Lower, because interest expense will be higher

Finally, for a given lease, a higher discount rate will accentuate the front-loading of total lease expense impacting, for example, the profile of PBT and EPS over the lease term. This is because a higher discount rate reduces total depreciation expense (typically recognised on a straight-line basis) and increases total interest expense (recognised on a front-loaded basis).

 **Will a lessee typically use the interest rate implicit in the lease or its incremental borrowing rate?**

A lessee will often struggle to determine the interest rate implicit in the lease – see Section 3.2 for a discussion of the challenges. Therefore, we expect that lessees will usually use their incremental borrowing rate.

3.2

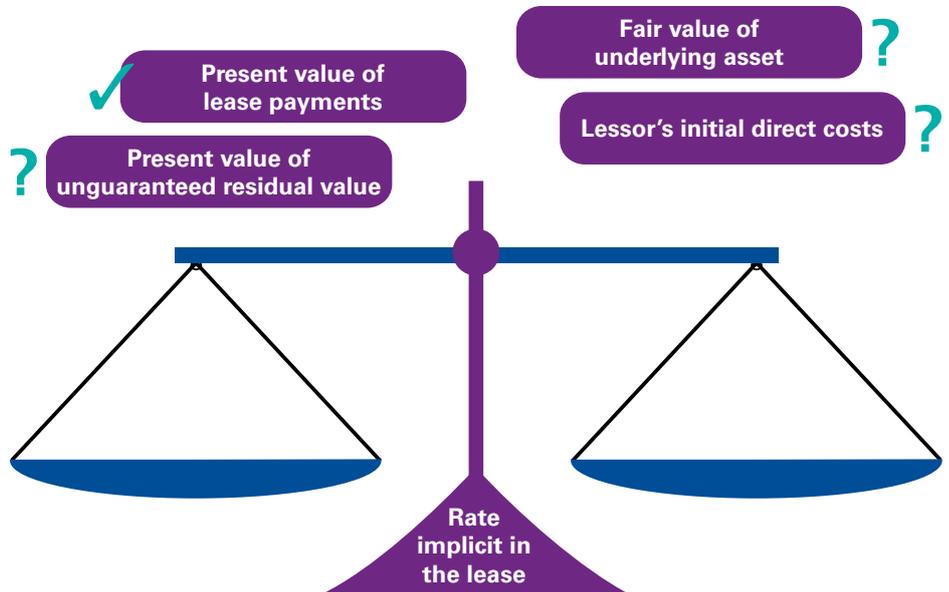
IFRS 16.A

Implicit rate – Lessee issues

There is no separate definition of the interest rate implicit in the lease from the lessee’s perspective. That is, for both the lessee and the lessor the interest rate implicit in the lease is the discount rate at which:

- the sum of the present value of (i) the lease payments and (ii) the unguaranteed residual value *equals*
- the sum of (i) the fair value of the underlying asset and (ii) any initial direct costs of the lessor.

However, the lack of information available to the lessee will typically make it difficult for the lessee to determine the interest rate implicit in the lease.



Why is it so hard for a lessee to determine the interest rate implicit in the lease?

1. The interest rate implicit in the lease is a company-specific measure – specific to the lessor. This can be seen most clearly by considering the lessor's initial direct costs. These are the costs incurred by the lessor that would not be incurred if the lease did not go ahead.

For example, if the lessor remunerates the team that negotiates the lease by paying an hourly rate irrespective of whether the lease is completed, then the lessor will have no initial direct costs. Conversely, if the lessor paid the same team (internal or external) a contingent fee that depended on whether the lease was completed, then the contingent amount would be an initial direct cost.

In general, the lessee will not know the absolute amount of the costs incurred by the lessor in negotiating the lease or whether a given cost would qualify to be an initial direct cost.

2. 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. A lessee usually will not have the information to determine both of these amounts unless the underlying asset is acquired by the lessor at lease inception and 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.

Lessees should bear in mind that regulators may challenge their determination of the interest rate implicit in the lease.



Can a lessee just ask the lessor what the implicit rate is?

Information obtained from the lessor may be a key input into a lessee's determination of the interest rate implicit in the lease.

However, this rate is likely to be a commercially sensitive figure. Some lessors will 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, the lessee should exercise appropriate professional scepticism when evaluating this information. In practice, due diligence procedures may be required before a lessee can determine a discount rate from information provided by a lessor.



What should a lessee consider when determining the initial fair value of the underlying asset, the residual value of the underlying asset and the lessor's initial direct costs?

In some cases, a lessee may be able to determine the initial fair value of an underlying asset – e.g. if there are widely quoted market values that are not susceptible to change based on negotiation between parties to individual transactions.

Similarly, in some cases a lessee may be able to determine the residual value of an underlying asset – e.g. if there are widely quoted market values that are assumed by lessors to change over time on a standardised basis for the purpose of pricing leases, or if there is a generally accepted transaction price for second-hand assets of a particular age and condition – e.g. some motor vehicles.

A lessee may also be able to assess that the lessor's initial direct costs are insignificant, in the sense that any reasonable estimate of the lessor's initial direct costs would not have an impact on the discount rate.

In some industries such as aircraft leasing, lessees may obtain information on initial direct costs from lessors through the process of negotiating leases, or through their due diligence processes.

IFRS 16.26, BC161



When might a lessee be able to readily determine the implicit rate?

It is likely to be difficult or impossible for lessees to readily determine the implicit rate for most leases. However, there may be some cases in which lessees might be able to readily determine the implicit rate.

For the lessee to use the implicit rate, that rate needs to be *readily determinable*. A lessee may be able to demonstrate that the implicit rate can be readily determined by considering the following.

- Reliable information may be made available to determine the initial fair value of the underlying asset, the residual value of the underlying asset and the lessor’s initial direct costs (as explained above).
- There may be circumstances, although limited, in which disclosure of the implicit rate is made available – e.g. in intra-group transactions, some related party transactions and some highly structured transactions in which all parties conducted extensive due diligence.

Overall, we expect that there will be few cases where a lessee will be able to readily determine the implicit rate. In any event, when the implicit rate can be readily determined, the assumptions and information used by the lessee must be consistent with those used by the lessor. The lessee should exercise appropriate professional scepticism when determining whether the implicit rate can be *readily determined*.

IFRS 16.A, 15, 27(c), 70(c)



When determining the interest rate implicit in the lease, should a lessee use the same lease payments as the lessor?

Yes. When determining the interest rate implicit in the lease, a lessee uses the ‘lease payments’ as defined in the new standard.

However, lease payments are defined differently for lessors and lessees. The two key differences in the definition of lease payments for lessors and lessees are as follows.

	Lessee	Lessor
Residual value guarantee	Includes in lease payments amounts <i>expected</i> to be payable under residual value guarantees that it provides to the lessor.	Includes in lease payments residual value guarantees provided by the lessee, a party related to the lessee or a third party unrelated to the lessor that is financially capable of discharging the obligations under the guarantee.

	Lessee	Lessor
Non-lease components	If a lessee uses the practical expedient in paragraph 15 of IFRS 16 not to separate non-lease components, then it includes in the lease payments the associated payments allocated to non-lease components.	Excludes payments allocated to non-lease components from the lease payments.

It appears that the lessee should use the lease payments as defined for the lessor when determining the rate implicit in the lease. This is because the rate implicit in the lease is a company-specific rate – specific to the lessor.

The IASB’s objective in specifying the discount rate to apply to a lease was to specify a rate that reflects the inputs considered by the lessor when pricing the contract. The lessor would consider the residual value guarantees from which it benefits. Furthermore, if the lessee were to use its lease payments as they are defined, then this would mean that the discount rate would depend on its accounting policy election for separation of non-lease components, rather than the pricing of the contract, which is not acceptable.

IFRS 16. BC160

3.3

Incremental borrowing rate

IFRS 16.A

The lessee’s incremental borrowing rate is a defined term in the new standard. It is 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.

IFRS 16.A

That is, the rate is specific to:

– the lessee – i.e. it is a company-specific rate that reflects the credit-worthiness of the company;	<p>Company A</p> 
– the term of the arrangement;	
– the amount of the funds ‘borrowed’;	
– the ‘security’ – i.e. the nature and quality of the underlying asset; and	

<p>– the economic environment, encompassing the jurisdiction, the currency and the date at which the lease is entered into.</p>	
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IFRS 16.A

 **Can a lessee with a good credit rating assume that its incremental borrowing rate is the same for all leases?**

No. The definition of an incremental borrowing rate indicates that it is the rate that a lessee would have to pay to borrow funds – i.e. a rate specific to the lessee. This is similar to a company borrowing funds collateralised or secured by an asset.

In practice, credit rating is one of many factors that lenders consider when determining the amount of funds to lend to a company and the interest rate to apply. The higher the credit rating, the less likely the lender (or, in the case of a lease, the lessor) is concerned that the borrower/lessee will default on payment, resulting in a lower rate. A company’s credit rating is based on its history of borrowing and paying debts due, the length of its credit history, evidence of default, its current ability to repay debts and its future economic outlook. Therefore, a company’s credit rating is subject to change over time and may not be the same at the time of entering into each of its leases.

The incremental borrowing rate is also impacted by other factors, which could result in a different rate for each lease.

IFRS 16.A

 **Is the incremental borrowing rate different for every lease?**

Yes, except for leases that qualify for a portfolio approach as discussed in Section 4.4. The incremental borrowing rate as defined in the new standard is a rate that is determined at the contract or individual lease level. In addition to credit ratings, other factors that impact it include the nature of the security, the amount of funds borrowed and the term of the borrowings. For example, the impact of these factors on the incremental borrowing rate generally is as follows.

Factor		Impact on incremental borrowing rate
	Quality of security	
	Amount of funds borrowed	
	Borrowing term	

A lessee may operate in multiple jurisdictions and the economic environment in those jurisdictions would also influence its incremental borrowing rate. These factors would vary from lease to lease, resulting in different incremental borrowing rates for every lease.

 **Example 2 – Comparison: Factors that affect the incremental borrowing rate**

If Company B enters into a building lease and a vehicle lease, then it needs to consider the following factors:

– the term of the arrangement;	10 years	5 years
– the amount of the funds ‘borrowed’;	1,000,000	100,000
– the ‘security’ – i.e. the nature and quality of the underlying asset; and		
– the economic environment, encompassing the jurisdiction, the currency and the date at which the lease is entered into.	 Lease entered into on 1 January 2015	 Lease entered into on 1 January 2017

Therefore, it is highly likely that B will conclude that it has a different rate for each lease.

However, as a practical expedient, a lessee may determine a single discount rate for a portfolio of leases with similar characteristics (see Section 4.4). This is permitted if the lessee expects that this approach would not differ materially from applying the standard to individual leases.

IFRS 16.A



Can a lessee use its weighted-average cost of capital rate as its incremental borrowing rate?

No. Weighted-average cost of capital (WACC) is a rate that incorporates the market's view of how a company would structure its financing using both debt and equity optimally over the long term, with each having a different rate of return. WACC includes all sources of finance, including equity, whereas the incremental borrowing rate is a rate that considers only borrowings.

A company's WACC is not specific to a lease contract and does not take into account the term, security and value of the underlying asset in a lease. As such, it does not meet the new standard's definition of a lessee's incremental borrowing rate.

In some cases, a company's WACC may be a useful input when determining the incremental borrowing rate. However, in practical terms a company may often find that it would be more effective to use an unsecured borrowing rate as an input, because fewer adjustments would be necessary.

IFRS 16.A, IAS 21.8



How should a lessee determine its incremental borrowing rate for a lease denominated in a currency that is different from its functional currency?

The lessee determines the rate at which it would borrow in the currency in which the lease is denominated.

The definition of incremental borrowing rate refers to the rate 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*.

In some cases, the lease contract is denominated in a currency that is different from the company's functional currency (i.e. the currency of the primary economic environment in which the company operates) – e.g. an aircraft lease is denominated in US dollars, but the company's functional currency is euros. In this case, the incremental borrowing rate is determined by using the currency in which the lessee would have to borrow the funds necessary to obtain an asset of a similar value to the right-of-use asset – i.e. US dollars.

**How should a lessee determine its incremental borrowing rate for a big-ticket lease when lenders apply a loan-to-value ratio?**

The definition of incremental borrowing rate indicates that it is the rate that a lessee would have to pay to *borrow* the funds necessary to obtain *an asset of a similar value* to the right-of-use asset. This is similar to a company borrowing funds collateralised or secured by an asset. In practice, lenders may only provide partial funding for the acquisition of big-ticket assets – e.g. aircraft, ships or buildings. Although this is not specifically addressed in the new standard, it appears that the incremental borrowing rate should be calculated using a ‘blended’ or ‘weighted’ rate at which the lessee would raise finance for 100% of the cost of an underlying asset.

**Example 3 – Determining the lessee’s incremental borrowing rate for big-ticket leases with an LTV ratio**

Company B has a shipping lease in which a loan-to-value (LTV) ratio of 80% applies (i.e. the lender provides funding for only 80% of the value of the ship) and the remaining 20% of the value is financed by equity.

In this case, the 20% equity finance is excluded from the calculation of the incremental borrowing rate because it does not reflect a rate at which B would have to borrow the funds necessary to obtain the asset. Instead, B will consider other sources of debt finance for the remaining 20% (e.g. bank loans, overdrafts etc). B will then determine a ‘blended’ or ‘weighted’ rate as follows:

$$(80\% \times \text{rate for secured borrowing}) + \\ (20\% \times \text{rate for general borrowings})$$

In other cases, a lender may offer to finance 100% of the cost of a ship, but at a premium rate. In these cases, it appears that B would determine its incremental borrowing rate by considering how it would arrange its borrowings in practice. That is, the incremental borrowing rate would be the lower of:

- the ‘blended’ or ‘weighted’ rate described above: i.e. $(80\% \times \text{rate for secured borrowing}) + (20\% \times \text{rate for general borrowings})$; or
- the premium rate that a lender would charge if it financed 100% of the purchase of a ship.

In each case, this rate will need to be adjusted for other factors (as appropriate) – e.g. the lease term compared with the loan duration, the security’s age and quality, and the lessee’s credit rating.

4

Specific scenarios

Additional considerations will apply when determining an appropriate discount rate in the following scenarios.

4.1

IFRS 16.BC162

Property leases

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 an input when determining its incremental borrowing rate for a lease – e.g. a property yield when determining the discount rate to apply to property leases. A lessee adjusts these observable rates as needed to determine its incremental borrowing rate as defined in the new standard.

By nature, property generally has significant residual values at the end of the lease. Property values usually increase over time and it is common in some jurisdictions for lease terms to be long – e.g. 99- or 999-year leases. These characteristics make it difficult for property lessees to determine an appropriate discount rate.



Can a lessor and a lessee use the property yield as the implicit rate?

No. A lessor uses the implicit rate for lease classification and measurement of finance leases (see Section 2.1). The IASB's objective was to specify a rate that reflects how the contract is priced, which is reflected in the implicit rate. The lessor will have the necessary information to determine the implicit rate.

A lessee uses the implicit rate if it can readily be determined. If it cannot, then a lessee uses its incremental borrowing rate. For leases of property, a property yield can be used as an *input* when determining the incremental borrowing rate for property leases (not the implicit rate).

IFRS 16.63(d), 68, 70, BC160

IFRS 16.26



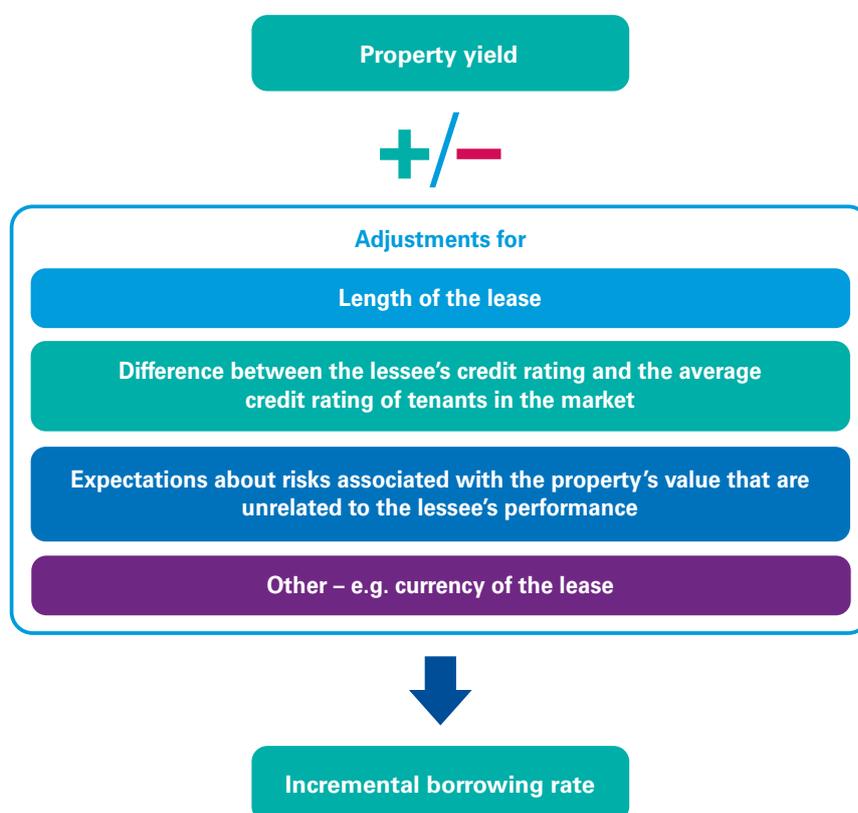
How should a lessee adjust an observable rate to derive an incremental borrowing rate?

As mentioned above, it might be acceptable for a lessee to use a readily observable rate such as an observable property yield as an input in determining its incremental borrowing rate. Property yields reflect the annual return expected on a property. They may be quoted before or after expenses (gross or net yield) and are a function of numerous factors, including but not limited to:

IFRS 16.BC162

- the market rental rates for the type of property;
- expectations about growth (e.g. a low property yield is often associated with higher rental growth expectations);
- expectations about renovation costs and;
- expectations about the risks associated with the property's value.

These factors indicate that property yields are specific to a particular property. However, property yields do not consider company-specific features that would affect the lessee's incremental borrowing rate – e.g. the length of the lease, the lessee's credit rating etc. Therefore, adjustments to the property yield will be required to determine the lessee's incremental borrowing rate.



In practice, the number and complexity of the adjustments may make it difficult for a lessee to use property yields as an input to determine its incremental borrowing rate.

As an alternative, it might also be acceptable for a company to use its general borrowing rate as an input in determining its incremental borrowing rate. This rate is company-specific (e.g. it includes the lessee's credit rating) but does not consider the features specific to the leased property (e.g. lease term). Therefore, adjustments will be required to determine the lessee's incremental borrowing rate – e.g. adjustments for the lease term, security of an item with the underlying nature of the leased asset, expectations of residual value risk etc.

**Will an incremental borrowing rate based on a property yield be higher?**

No. In some jurisdictions, property yields are generally higher than borrowing rates and some lessees might prefer to use a property yield as the incremental borrowing rate because this would result in a lower lease liability.

However, if a property yield is used as an input in determining the incremental borrowing rate then the lessee will need to adjust it as needed (see above) to ensure that the resulting incremental borrowing rate complies with the definition in the standard. Regardless of whether a property yield is used as an input in determining the lessee's incremental borrowing rate, the incremental borrowing rate cannot exceed the rate that is required by the standard.

4.2

Group situations

Some lessees conduct all of their financing at a consolidated group level and some have no other sources of financing other than the parent company. There is no specific guidance in the new standard on how to determine an appropriate incremental borrowing rate in these cases.

**Can a subsidiary use the parent or group rate in its separate financial statements?**

No. As a principle, the subsidiary cannot automatically default to using its parent or group rate in its separate financial statements. However, in some cases it might be reasonable for a subsidiary to use its parent's or group's incremental borrowing rate as an input and would need to adjust it as needed when determining the appropriate discount rate for a lease. For example, this might be appropriate when the subsidiary does not have its own treasury function, all funding for the group is managed centrally by the parent and this results in the parent providing a guarantee of the lease payments to the lessor. In this case, the pricing of the lease may be more significantly influenced by the credit standing of the parent than that of the subsidiary.

IFRS 16.BC160

4.3

Reassessments and modifications

IFRS 16.41, BC193–BC194

In many cases, a lessee does not reassess the discount rate during the lease term. This is generally consistent with the approach applied to financial instruments accounted for under the effective interest rate method. However, a lessee will revise the discount rate in certain cases when there is a reassessment of the lease liability or a lease modification, as outlined below.

In these cases, the economics of the lease have changed and it is appropriate to reassess the discount rate.

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. If the implicit rate cannot be readily determined, then the revised discount rate is the lessee's incremental borrowing rate at the date of reassessment or effective date of the lease modification.

Generally, a lessor does not reassess the discount rate, but will use a revised discount rate in some modification scenarios.

IFRS 16.40–41, 43, 45, A, BC193–BC195



In which reassessment scenarios does a lessee revise the discount rate?

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;
- a change in the assessment of whether the lessee is reasonably certain to exercise an option to purchase the underlying asset; or
- a change in floating interest rates, resulting in a change in future lease payments (this approach is consistent with IFRS 9's requirements for the measurement of floating rate financial liabilities subsequently measured at amortised cost).

A lessee does not reassess the discount rate when there is a change in future lease payments due to a change in an index – e.g. the consumer price index.

IFRS 16.44–45



In which modification scenarios does a lessee revise the discount rate?

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

Although the lease modification guidance is complex, there are essentially two possible outcomes, as follows.

Modification	Impact
The modification is accounted for as a separate lease.	The lessee does not revise the discount rate for the original lease. However, the lessee is required to determine a discount rate for the modification itself, which is accounted for as a separate lease.
The modification is not accounted for as a 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. the 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.

IFRS 16.79–80, 87

 In which modification scenarios does a lessor revise the discount rate?	
<p>Whether a lessor revises the discount rate on a lease modification depends on whether the modification is accounted for as a separate lease and on the lease classification.</p>	
Modification	Impact
The modification of a finance lease is accounted for as a separate lease.	The lessor determines the rate implicit in that separate lease. The lessor does not revise the discount rate of the original lease.
The modification of a finance lease is not accounted for as a separate lease and the lease would have been classified as a finance lease had the modification been in effect at inception.	The lessor accounts for the modification in accordance with IFRS 9.
The modification of a finance lease is not accounted for as a separate lease and the lease would have been classified as an operating lease had the modification been in effect at inception.	The lessor accounts for the modification as a new lease from the effective date of the modification and measures the carrying amount of the underlying asset as the net investment in the lease immediately before that date. The lessor is not required to identify a discount rate for its subsequent accounting.
The modification to an operating lease is accounted for as a new lease.	If required, the lessor determines the rate implicit in that new lease considering any prepaid or accrued lease payments relating to the original lease as part of the lease payments for the new lease.

4.4

IFRS 16.C5, C10

IFRS 16.C6

Transition

A lessee is permitted to:

- adopt the standard retrospectively; or
- follow a modified retrospective approach with some optional practical expedients. Under this approach, a lessee does not restate comparative information. Instead, it recognises the cumulative effect of initially applying the standard as an adjustment to equity at the date of initial application.

A lessee applies the election consistently to all of its leases.

IFRS 16.C14

Except for sub-leases, a lessor is not required to make any adjustments on transition. Instead, a lessor accounts for its leases in accordance with the new standard from the date of initial application.



What discount rate information is needed under the retrospective approach?

IFRS 16.C5(a)

Under the retrospective approach, a lessee applies the new standard to each prior reporting period presented applying IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors*.

A lessee will therefore require extensive information about its leasing transactions to apply the standard retrospectively, including historical information about discount rates. It will include the historical information that management would have used to make the various judgements and estimates that are necessary to apply the lessee accounting model – e.g. for determining the interest rate implicit in the lease (if it is readily determinable) or the incremental borrowing rate.

The information will be required at lease commencement, and as at each subsequent date on which the company would have been required to recalculate lease assets and liabilities on a reassessment or modification of the lease.



What discount rate information is needed under the modified retrospective approach?

IFRS 16.C5(b), C8(a)

For leases previously classified as operating leases, a lessee measures the lease liability at the date of initial application as the present value of the remaining lease payments. The discount rate is the lessee's incremental borrowing rate at that date; there is no option to use the rate implicit in the lease.



Is additional discount rate information needed under the modified retrospective approach if the lessee elects to measure a right-of-use asset retrospectively?

IFRS 16.C8

No. Under the modified retrospective approach, the lessee uses the incremental borrowing rate at the date of initial application, irrespective of how it chooses to measure the right-of-use asset.

For leases previously classified as operating leases, a lessee is permitted to choose, on a lease-by-lease basis, how to measure the right-of-use asset using one of two methods.

- *Option 1*: as if the new standard had always been applied (but using the incremental borrowing rate at the date of initial application).
- *Option 2*: at an amount equal to the lease liability (subject to certain adjustments).

However, in both cases it uses the incremental borrowing rate at the date of initial application.

For example, if a lease was modified before the date of initial application and the lessee elects Option 1 for the right-of-use asset in that lease, then it uses the incremental borrowing rate at the date of initial application to measure the right-of-use asset before and after the modification. This contrasts with full retrospective application, which would require the lessee to determine a new discount rate at the date of the modification – see Section 4.3.

IFRS 16.C10



Are there any practical expedients for discount rates on transition to the new standard?

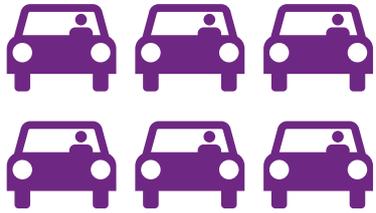
Yes. Under the modified retrospective approach only, a lessee may apply a single discount rate to a portfolio of leases with reasonably similar characteristics – e.g. leases with a similar remaining lease term for a similar class of underlying asset in a similar economic environment. This practical expedient is applied on a lease-by-lease basis.

There are no practical expedients for the lessor as the lessor is not required to make any adjustments on transition to the new standard.



Example 4 – Practical expedients for the lessee on transition

Company B is a lessee in the airline industry and has multiple types of leases with different classes of underlying assets – e.g. aircraft, property and motor vehicles. B may consider using the practical expedient as follows.

Company B's leases	Practical expedient considered on a lease-by-lease basis
	<p>B 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.</p>
	<p>B may determine that its properties and aircraft have different characteristics and terms, therefore requiring different discount rates to be determined for each individual asset.</p>
	

IFRS 16.B1, C10(a)



Is this practical expedient different from the general guidance on portfolio accounting?

At first glance, this practical expedient seems similar to the general guidance on portfolio application, which permits a company to apply the new standard to a portfolio of leases with similar characteristics.

However, there are some differences, as follows.

- First, there are fewer conditions to apply the practical expedient on transition. The general guidance on portfolio application can be applied only if the company can demonstrate that the effect of applying the new standard to the portfolio is not materially different from applying it to individual leases. In contrast, the practical expedient on transition is available whenever the leases have similar characteristics.
- Second, the practical expedient on transition refers to leases with ‘a similar *remaining* lease term’. This is consistent with the general focus on the remaining term in a modified retrospective approach.

Overall, the hurdle for using the practical expedient on transition is lower than the hurdle for portfolio application of the new standard subsequently.

5

Next steps

5.1

Transition considerations

A key early decision is how to transition to the new standard. For many companies, the choice of transition method and which practical expedients to apply will have a major impact on the cost of implementing the new standard and the comparability of trend data in the years after transition. The transition option will have a significant impact on the discount rate applied, the extent of data gathering and the timing of system and process changes, and should be considered as soon as possible.

The worked example in Appendix II to this publication illustrates the radically different information requirements under different transition approaches.

Our [Leases: Transition options](#) provides additional guidance to help you make the transition.

5.2

Practical steps for the lessee

The discount rate used by the lessee will have a significant impact on the initial measurement of the lease liability and a potentially pervasive impact on the financial statements – on depreciation and interest profiles subsequently and a follow-on effect on key ratios.

Further, under the modified retrospective transition approach, a lessee will need to determine its incremental borrowing rate at the date of initial application. That is, the lessee cannot use the interest rate implicit in the lease under this approach.

A lessee should therefore consider the extent of data gathering, system and process changes, and estimation techniques to derive the incremental borrowing rate. Advance planning will allow time for proper estimation and unanticipated complexities, and will offer greater flexibility in maximising the portfolio approach practical expedient.

A lessee should consider the following actions.

- Compile an inventory of all of its leases, including the relevant terms and conditions.
- Determine its transition approach (see Section 4.4).
- Identify the population of leases for which it needs to determine a discount rate (see Section 3.1 for examples of when a lessee does not need to determine a discount rate).
- Identify leases with similar characteristics such as similar remaining lease term for a similar class of underlying asset in a similar economic environment.
- Decide which groups of leases it will apply the portfolio approach practical expedient to (if it is applying the modified retrospective approach).
- Determine the appropriate discount rates for its leases.
- Document judgements, assumptions and calculations made in determining the rates used for its leases.

5.3

Pre-adoption disclosures

Lessees and lessors will need to prepare for the pre-adoption disclosures. IAS 8 requires disclosures about standards that have been issued but are not yet effective. Regulators have openly said that this disclosure will be a focus area for the upcoming new standards on revenue recognition and leases. As the application date approaches, it is expected that more detailed information will be disclosed.

Appendix I – IFRS 16 at a glance

Topic	Key fact
Lease definition	<ul style="list-style-type: none"> – New lease definition with an increased focus on control of the underlying asset
Lessee accounting model	<ul style="list-style-type: none"> – Single lease accounting model – No lease classification test – Most leases on-balance sheet: <ul style="list-style-type: none"> - lessee recognises a right-of-use asset and lease liability - treated as the purchase of an asset on a financed basis
Lessor accounting model	<ul style="list-style-type: none"> – Dual lease accounting model for lessors – Lease classification test based on IAS 17 <i>Leases</i> classification criteria – Finance lease accounting model based on IAS 17 finance lease accounting, with recognition of net investment in lease comprising lease receivable and residual asset – Operating lease accounting model based on IAS 17 operating lease accounting
Practical expedients and targeted reliefs	<ul style="list-style-type: none"> – Optional lessee exemption for short-term leases – i.e. leases for which the lease term as determined under the new standard is 12 months or less and that do not contain a purchase option – Portfolio-level accounting permitted for leases with similar characteristics if the effect on the financial statements does not differ materially from applying the requirements to individual leases – Optional lessee exemption for leases of low-value items – i.e. underlying assets with a value of USD 5,000 or less when they are new – even if they are material in aggregate
Effective date	<ul style="list-style-type: none"> – Accounting periods beginning on or after 1 January 2019 – Early adoption is permitted if IFRS 15 <i>Revenue from Contracts with Customers</i> is also adopted – Date of initial application is the beginning of the first annual reporting period in which a company first applies the standard

Appendix II – Transition example

This worked example uses a fictional company adopting the new standard to show the different information needs of the transition options.

1 Scenario

Propola plc is a retailer that sells clothes made with ethically sourced cotton. It prepares financial statements for annual periods ending on 31 December, and includes one year of comparatives in its financial statements.

Propola has been trading for many years. The business is mature, with generally stable financial results.

Propola purchases power from a supplier of renewable energy under a long-term power purchase agreement. It leases the stores from which it operates, the vehicles that it uses to make deliveries and a variety of point-of-sale and other IT equipment used in its stores.

2 Lease information

Propola has completed an inventory of leases in which it is a lessee, which it has grouped into four categories for the purposes of its IFRS 16 implementation project. Propola does not act as a lessor.

	Power purchase agreement	Stores	Vehicles	Point-of-sale and other IT equipment
Under IAS 17/ IFRIC 4	Lease	Leases	Leases	Leases
Under IFRS 16	Not a lease, because Propola does not have the right to direct the generating plant	Leases	Leases	Leases – Propola elects the recognition exemption for leases of low-value items
Number of contracts at any point in time	1	10	20	n/a

	Power purchase agreement	Stores	Vehicles	Point-of-sale and other IT equipment
Commencement date	1 January 2008	New leases signed on 1 July each year	New leases signed on 1 January, 1 April, 1 July and 1 September each year	n/a
Term	20 years	10 years	5 years	n/a

3 Discount rate information needed on transition

3.1 Retrospective approach

General requirement

Power purchase agreement*	Stores	Vehicles
Propola needs to determine its historical incremental borrowing rate at <i>commencement</i> of the contract (i.e. 1 January 2008).	Propola needs to determine its historical incremental borrowing rate at <i>commencement</i> of <i>each</i> lease signed every July for the last 10 years before transition (i.e. the leases that would be in existence at 1 January 2018 – the earliest comparative period presented).	Propola needs to determine its historical incremental borrowing rate at <i>commencement</i> of <i>each</i> lease signed on 1 January, 1 April, 1 July and 1 September each year for the last 5 years (i.e. the leases that would be in existence at 1 January 2018 – the earliest comparative period presented).

Is a portfolio approach relevant?

Sources of data

Additional considerations

	Power purchase agreement*	Stores	Vehicles
Is a portfolio approach relevant?	<p>No.</p> <p>This contract is unique from Propola's perspective and it will be required to determine a rate that is specific to the contract.</p>	<p>No.</p> <p>The store leases are similar in terms of the nature of the underlying asset and lease term. However, they were entered into at different dates, and property is a volatile asset class in many jurisdictions. It is therefore likely that Propola cannot treat the stores as a portfolio for the purposes of determining the discount rate. Instead, it will need to determine a discount rate for each store.</p>	<p>Maybe.</p> <p>The vehicle leases are similar in terms of the nature of the underlying asset and lease term. Although they were entered into at different times, the time periods between leases are relatively short.</p> <p>Propola may be able to identify portfolios of vehicles leases – e.g. all those entered into in a financial year, or between changes in bank base rates.</p>
Sources of data	<p>An important source of information is likely to be the board papers and due diligence reports prepared when the contract was entered into.</p>	<p>Important sources of information may include investment appraisals and contemporaneous advice from property consultants for each lease. Propola may also consider seeking new advice from property consultants on historical market information.</p>	<p>Important sources of information may include the secured borrowing rate for vehicle purchases adjusted for the premium that lessors would charge for the asset risk in a lease.</p>
Additional considerations	<p>Given the nature and complexity of the contract, it is possible that the contract will have been modified subsequently. If so, then Propola will consider whether the discount rate should be revised at the date of each modification.</p>	<p>Propola may find that its incremental borrowing rate for its store leases changed significantly in the period 2008–18, reflecting changes in market conditions in that period. In turn, this will impact the measurement of its lease assets and liabilities.</p>	<p>Given industry developments, including an increased focus on electric vehicles, Propola may expect volatility in residual values in the run-up to 2019. Propola will need to ensure that the rate reflects conditions as at the commencement date of each lease.</p>

Power purchase agreement*	Stores	Vehicles
The contract commenced in 2008, as the global financial crisis was developing. Interest rates may have been volatile at the time, so Propola will need to ensure that the rate reflects conditions as at the commencement date.		

Propola does not need to determine discount rates for its many leases of point-of-sale and other IT equipment. This is because it intends to apply the recognition exemption for leases of low-value items to these leases.

* This information is required only if Propola elects the practical expedient to grandfather its assessment of which contracts were identified as leases under IAS 17/IFRIC 4. If Propola applies the lease definition retrospectively, then it would account for this contract off-balance sheet as an executory contract; it would not need to determine a discount rate.

3.2 Modified retrospective approach

Power purchase agreement*	Stores	Vehicles
Propola needs to determine its incremental borrowing rate at the date of initial application of IFRS 16 (i.e. 1 January 2019).	Propola needs to determine its incremental borrowing rate for its store leases at the date of initial application of IFRS 16 (i.e. 1 January 2019).	Propola needs to determine its incremental borrowing rate for its vehicle lease at the date of initial application of IFRS 16 (i.e. 1 January 2019).

Similar to the retrospective approach, Propola does not need to determine discount rates for its many leases of point-of-sale and other IT equipment. This is because Propola intends to apply the recognition exemption for leases of low-value items to these leases.

* This information is required only if Propola elects the practical expedient to grandfather its assessment of which contracts were identified as leases under IAS 17/IFRIC 4. If Propola applies the lease definition retrospectively, then it would account for this contract off-balance sheet as an executory contract; it would not need to determine a discount rate.

4 Conclusion

As illustrated above, the information about discount rates that Propola needs on transition depends significantly on the choices and elections that it makes regarding how it transitions to the new standard. Key considerations include whether Propola:

- follows a retrospective or modified retrospective approach;
- applies the practical expedient to grandfather its assessment of which transactions are leases under IAS 17/IFRIC 4;
- elects the recognition exemptions for short-term leases and leases of low-value items; and
- identifies portfolios of similar leases.

Early decisions on transition method are therefore essential in order to scope the exercise that Propola – or any other company – needs to undertake to gather relevant information on discount rates.

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Further analysis and interpretation will be needed for a company to consider the impact of IFRS 16 in light of its own facts, circumstances and individual transactions. The information contained in this publication is based on initial observations developed by the KPMG International Standards Group and these observations may change. Accordingly, neither this publication nor any of our other publications should be used as a substitute for referring to the standards and interpretations themselves.

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