ESTIMATING THE IBR UNDER ASC 842

In 2016, the FASB published guidance that will require a majority of today's operating leases to be reported on the balance sheet starting in 2019.

RIGHT-OF-USE MODEL

At commencement, the lessor conveys the right to use the underlying asset and the lessee has a financial obligation to make lease payments to the lessor for this right.

Lessee Recognition under ASC 842

- Lessees' asset and liability are recognized at present value using the lease payments and a discount rate applicable to *the lease*.
- The discount rate for the lease should be the "rate implicit in the lease".
- When the rate implicit in the lease is not readily determinable, the lessee is required to use its INCREMENTAL BORROWING RATE (IBR).

ASC 842 defines the IBR as *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.*

From this definition, there are several factors to consider:

- Corporate credit rating and borrowing rates;
- Lease terms including maturity, defined payments, termination and renewal options;
- Credit quality of underlying collateral;
- Denominated currency;
- Macro-economic and market data.

The lessee should estimate an IBR considering the lessor can seek general recourse to other assets of the lessee (analogous to corporate debt).

Only asset-specific collateralization is applicable under the guidance.

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Estimating the Incremental Borrowing Rate

IBR is estimated using industry-accepted credit analysis methodology. Oracle Capital's steps to estimating the IBR can be summarized as follows:

Assessment of credit quality of the lessee

- Public credit rating
- Synthetic credit rating

Analyze observable market debt yield curves

- Lessee-specific issuances
- Comparable public corporate debt
- Debt indices

Adjust market debt yield curves

- Foreign currency/country considerations
- Seniority/subordination
- Embedded lease options
- Lease term/maturity

Lessee-specific Observable Borrowing Costs

Standard measures of borrowing cost may not be appropriate under ASC 842 or will need modifications to be applicable. Below are common initial conclusions for IBR and potential issues for which adjustments may be necessary:

- **Revolver/Line of Credit**
  - Senior/overcollateralized with cash
  - Shorter term (i.e. 1-2 years)
  - May not reflect current actual market-based borrowing rates for lessee
- **Term Loan**
  - Instrument-specific factors (embedded options, floating vs. fixed rate, etc.)
- **Lessee Debt Issuances**
  - Lessee credit rating insight
  - Unsecured/subordinated standing
  - Collateralization compared to subject lease

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