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Ms Sue Lloyd
International Accounting Standards Board
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Dear Ms Lloyd

Tentative agenda decision: Lessee's incremental borrowing rate (IFRS 16 Leases)

We appreciate the opportunity to comment on the IFRS Interpretations Committee's (the Committee) tentative agenda decision *Lessee's incremental borrowing rate (IFRS 16 Leases)* (IFRIC Update June 2019). We have consulted with, and this letter represents the views of, the KPMG network.

Overall, we agree with the analysis of the issue in the Committee staff paper. However, we recommend that the wording of the tentative agenda decision be clarified to minimise the risk that it is read to suggest that a lessee has a wholly free choice on this and other issues when determining its incremental borrowing rate, as explained below.

The issue concerns whether a lessee's incremental borrowing rate must reflect the interest rate in a loan with both a similar maturity to the lease and a similar payment profile to the lease payments. This is a common practice question, the answer to which can have a significant impact on the measurement of the lessee's lease liability. For example, using an interest rate from a loan with a bullet repayment to determine the incremental borrowing rate for a lease with periodic payments will result in a higher discount rate and lower lease liability.

The analysis in the Committee staff paper turns on two key observations. The first is that the Board's intention when developing the definition of incremental borrowing rate "was for a lessee to start with the best information available and adjust accordingly" (paragraph 23 of the staff paper, citing IFRS 16.BC162). This suggests that a lessee will often – but not always – seek to reflect the interest rate in a loan that has a similar payment profile to the lease payments (paragraph 24). The second is that the Board decided not to provide application guidance about the lessee's incremental borrowing rate.

Clearly, there is a tension between these two observations. It is this tension that entities are seeking to navigate when determining an incremental borrowing rate. This is the case for the issue currently before the Committee, and for numerous other practice issues associated with determining an incremental borrowing rate – for example, whether to adjust for asset risk, liquidity, loan to value restrictions etc.

We consider that the tentative agenda decision does not capture this tension. In particular, the penultimate paragraph of the tentative agenda decision begins with a statement that there are no explicit requirements in IFRS 16, does not refer to the Board's objective when developing the definition, and states that an entity "may often" refer to a loan with a similar payment profile. We are concerned that this could be misread to suggest that an entity has a wholly free choice on this issue – and, by extension, other practice issues relating to the determination of incremental borrowing rate that IFRS 16 does not address explicitly. There is a risk that the tentative agenda decision as drafted could increase rather than decrease diversity in practice.

We therefore recommend that the paragraph be redrafted to emphasise that an entity seeks to apply the definition of incremental borrowing rate, in light of the Board's objective. We believe that this would be consistent with the analysis in the Committee staff paper and discussion, and reflective of the efforts many entities are making to apply the definition of incremental borrowing rate in practice. This would promote consistency in the application of the definition on this and numerous related issues. It would also be consistent with the Board's objective expressed in IFRS 16.BC160 that the discount rate should reflect how the contract is priced. The appendix to this letter includes a specific drafting suggestion in this regard.

In due course, the question as to whether IFRS 16 contains sufficient guidance to ensure consistency in the determination of the incremental borrowing rate could be a suitable topic for the post-issuance review of the standard.

Please contact Reinhard Dotzlaw or Kimber Bascom on +44 7694 8871 if you wish to discuss any of the issues raised in this letter.

Yours sincerely

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Appendix – drafting suggestion

Penultimate paragraph of tentative agenda decision as included in the IFRIC Update

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

Proposed alternative

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