Estimating an Incremental Borrowing Rate under ASC 842

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In February 2016, the Financial Accounting Standards Board (the "FASB") issued Accounting Standard Codification ("ASC") 842. This has been one of the biggest topics in financial reporting for the past few years. ASC 842 redefines Generally Accepted Accounting Principles ("GAAP") standards for the recognition of leases.

Under ASC 842, lessees must record operating and finance leases as a liability and an equal right of use asset, based on the present value of future lease payments. Previously, operating leases were off-balance sheet contracts. The applicable discount rate is the rate implicit in the lease or the lessee's incremental borrowing rate (private companies may elect to use a risk-free rate). ASC 842 defines the incremental borrowing rate as the rate that a lessee would have to pay to borrow on a collateralized basis an amount equal to the lease payments over a similar term in a similar economic environment. The new leasing standards under ASC 842 are required to be implemented starting with December 2018 year-end filings for public companies, and December 2019 year-end filings for private companies.

Lessees often lack the information necessary to determine the rate implicit in the lease; therefore, private and public companies may be required to estimate their incremental borrowing rates. The new standard creates two specific questions with regard to the incremental borrowing rate.

For public and private companies, what is an appropriate estimate of the incremental borrowing rate?

A company may be able to look at its recent borrowings to estimate an incremental borrowing rate. However, the definition of an incremental borrowing rate creates a framework of three key factors: (1) collateralized basis; (2) similar term; and (3) in a similar economic environment. Therefore, market data may provide a more accurate analysis within that framework to estimate the incremental borrowing rate.

As a simple example, consider Subject Company (a company in the food and beverage industry) with a five year operating lease with annual payments of $1.0 million starting on January 1, 2018. In order to develop an estimate of the incremental borrowing rate, a sample of nine comparable loans were identified and are presented in Supplemental Exhibit A. These loans were identified after first analyzing financial ratios for Subject Company to determine an appropriate credit rating. The sample had a range of yields of 4.5% to 8.5% with a median and mean of 5.8% and 5.9%, respectively. An incremental borrowing rate of 6.0% was selected based on the loan sample and qualitative, company-specific factors regarding Subject Company.

Current and industry specific loan data provides a framework for comparable market data. This data, in combination with a qualitative assessment of company specific factors, allows for a reasonable estimate of the incremental borrowing rate, especially when a company has not engaged in borrowings under similar circumstances of the lease.

SUPPLEMENTAL EXHIBIT A

COMPARABLE LEVERAGED LOANS
SUBJECT COMPANY
AS OF JANUARY 1, 2018

Issuer	CUSIP	Industry Group	Rank Type	Maturity Date	Moody's Credit Rating	S&P Credit Rating	Amount Outstanding ($MM)	Price (bid) as % of UPB	Years to Maturity	Yield to Worst
Blue Ribbon LLC	09582EAB2	Food & Beverage	1L,Sr.,Secd	11/13/2021	B2	B	$495.00	99.5%	3.9	5.8%
Utz Quality Foods LLC	91809EAB7	Food & Beverage	1L,Sr.,Secd	11/21/2024	B2	B	$535.00	100.5%	6.9	5.1%
Shearer's Foods LLC	82087UAG2	Food & Beverage	1L,Gtd,Sr.,Secd	07/30/2021	B3	B-	$225.00	99.9%	3.6	6.0%
Chobani LLC	17026YAD1	Food & Beverage	1L,Gtd,Sr.,Secd	10/07/2023	B1	B	$821.00	101.0%	5.8	5.0%
CSM Bakery Solutions LLC	60001PAB3	Food & Beverage	1L,Sr.,Secd	07/03/2020	B3	B-	$818.44	98.3%	2.5	6.5%
Shearer's Foods LLC	82087UAB3	Food & Beverage	1L,Gtd,Sr.,Secd	06/30/2021	B3	B-	$290.00	99.8%	3.5	5.3%
Winebow Group LLC	97382TAB6	Food & Beverage	1L,Sr.,Secd	07/01/2021	B1	B-	$230.00	98.1%	3.5	6.0%
Hearthside Group Holdings LLC	42234UAD5	Food & Beverage	1L,Gtd,Sr.,Secd	06/02/2021	B1	B	$664.87	100.5%	3.4	4.5%
Reddy Ice Corp	75734HAC1	Food & Beverage	1L,Sr.,Secd	04/01/2019	B3	B-	$225.00	98.5%	1.2	8.5%
							AVERAGE	**99.6%**	**3.8**	**5.9%**
							MEDIAN	**99.8%**	**3.5**	**5.8%**
							MINIMUM	**98.1%**	**1.2**	**4.5%**
							MAXIMUM	**101.0%**	**6.9**	**8.5%**

Note: Information from Bloomberg.

For private companies, what is the impact of the application of a risk-free rate versus an incremental borrowing rate?

Since ASC 842 allows lessees to select an appropriate discount rate based on the risk free rate or the incremental borrowing rate, private companies may want to consider the impact of the selected discount rate. The applicable discount rate can have significant implications for private companies when considering the use of a risk-free rate.

Again, let's consider the above Subject Company (again, a company in the food and beverage industry) with a five-year operating lease and annual payments of $1.0 million starting on January 1, 2018. Under the first scenario, we will apply the risk-free rate, based on the five-year U.S. Treasury rate of 2.20%. When doing so, the present value of the lease payments, and therefore the value of the operating lease liability and the right of use asset, was $4.7 million. See Supplemental Exhibit B.

Under the second scenario, we will apply Subject Company's estimated incremental borrowing rate. As previously discussed, an incremental borrowing rate of 6.0% was selected based on the loan sample presented in Supplemental Exhibit A, and qualitative, company-specific factors regarding Subject Company. Based on the previously discussed assumptions, the present value of lease payments was $4.3 million applying the estimated incremental borrowing rate of 6.0%. See Supplemental Exhibit B.

From the example above, the use of the estimated incremental borrowing rate, instead of the risk free rate, has an approximate $400,000 (or 7.6%) reduction to the operating lease liability and the right of use asset. Based on the example above, application of an estimated incremental borrowing rate, in comparison to a risk free rate, supports recognition of a reduced liability.

Current and industry specific loan data provides a framework for comparable market data. This data, in combination with a qualitative assessment of company specific factors, allows for a reasonable estimate of the incremental borrowing rate, especially when a company has not engaged in borrowings under similar circumstances of the lease.

SUPPLEMENTAL EXHIBIT B

PRESENT VALUE OF OPERATING LEASE LIABILITY
SUBJECT COMPANY
AS OF JANUARY 1, 2018

Lease Assumptions	
Lease Classification	Operating
Lease Term	5.0
Payments	Annual
Start Date	1/1/2018
Annual Lease Payments	$1,000,000

	Risk-free Rate		Incremental Borrowing Rate		Variance
Applicable Interest Rate	2.20%	(1)	6.00%	(2)	
Present Value of Lease Payments	$4,686,223		$4,329,477		-$356,746

(1) Risk-free rate based on 5 Year U.S. Treasuries at Valuation Date
(2) Selected incremental borrowing rate based on the leveraged loan sample presented in Supplemental Exhibit A.

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Anthony Venette, CPA/ABV, is a Valuation Consultant at Empire. Anthony has been involved in the valuation of various classes of equity, general and limited partnership interests, carried interest, limited liability company membership interests, C-Corporations, S-Corporations, stock options, and warrants. These valuations have been for purposes including gift and estate tax planning, financial reporting under ASC 820, employee stock ownership plan administration, and other corporate planning and reporting. Anthony received his BS degree in Accounting and his MBA with a concentration in Accounting from the St. John Fisher College Bittner School of Business.

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