



# Private Entities

## Amendments to Topic 842 risk-free discount rate practical expedient

November 11, 2021



Final ASU makes expedient electable by class of underlying asset and clarifies its interplay with the implicit rate.

### Applicability

ASU 2021-09, [Discount Rate for Lessees That Are Not Public Business Entities](#)

Applies to all entities that are not 'public business entities' as defined in US GAAP ('private entities'). This includes those not-for-profit entities (i.e. conduit bond obligors) and employee benefit plans that were required to adopt Topic 842 at the same time as public business entities.

### Fast facts, impacts, actions

Under Topic 842, the discount rate for the lease can materially affect the measurement of the lease liability and right-of-use (ROU) asset, and can also affect lease classification (i.e. as finance or operating).

The discount rate used by a lessee is the rate implicit in the lease if that rate can be readily determined. If not, which is typically the case, a lessee uses its incremental borrowing rate. However, private entities can elect to use a risk-free discount rate for all of the leases for which they are a lessee.

Lessees have told the FASB it is often complex and costly to estimate the incremental borrowing rate (e.g. if it is necessary to engage a valuation specialist). The FASB originally created the risk-free discount rate practical expedient because it was informed that this is especially true for private entities that do not have sophisticated treasury functions or publicly issued debt.

The final ASU :

- permits private entity lessees to elect the expedient by class of underlying asset, instead of requiring it to be applied to all leases if elected; and
- clarifies that a lessee must still use the rate implicit in the lease when it is readily determinable even if it has elected the expedient.

**Action:** Private entity lessees that have been reluctant to elect the expedient because it must be applied to *all* leases should reconsider their position. The amendments give them additional flexibility to use the practical expedient for most of their leases, but use their incremental borrowing rate for larger, more significant leases (e.g. leases of real estate), mitigating the negative balance sheet effect of electing the expedient.

## Background

The discount rate for a lease directly affects the measurement of the lease liability and ROU asset, as well as the classification of the lease as finance or operating. In a finance lease, the discount rate also affects the timing of lease cost recognition and the split between interest and ROU asset amortization.

The rate implicit in the lease is rarely readily determinable by the lessee, and lessees have said it is often complex and costly to estimate the incremental borrowing rate (e.g. if a valuation specialist must be retained). Further, estimating the incremental borrowing rate can be especially challenging for private entities that do not have a sophisticated treasury function, do not have publicly traded debt and/or lack access to financial data such as quoted credit spreads and corporate bond rates.

On the basis of this feedback, the FASB included in Topic 842 a practical expedient that permitted private entity lessees to use a risk-free discount rate, determined using a period comparable to that of the lease term. Pre-ASU 2021-09, the practical expedient was an accounting policy election that had to be applied to all of an entity's leases in which it is a lessee. However, despite the challenges in estimating their incremental borrowing rates, since Topic 842 was issued, many private entity lessees indicated a hesitancy to elect the practical expedient. This was primarily for two reasons.

- A risk-free rate (e.g. a US Treasury Rate or a foreign government bond rate) is often much lower than an entity's incremental borrowing rate. Therefore, it may give rise to larger lease liabilities and ROU assets when compared with those that would result from use of the incremental borrowing rate.
- The present value of the lease payments is increased by a low discount rate, so using a risk-free discount rate, instead of the lessee's incremental borrowing rate, can cause a lease that would otherwise be classified as an operating lease to be classified as a finance lease.

Another issue pertaining to the practical expedient stemmed from its wording in paragraph 842-20-30-3. Some stakeholders read the pre-ASU guidance to require a risk-free discount rate be used for all leases, regardless of whether the rate implicit in the lease is readily determinable. Other stakeholders read that same guidance to require that the lessee use the rate implicit in the lease if it is readily determinable, regardless of whether the lessee has elected the risk-free discount rate practical expedient.

## Amendments to the practical expedient

ASU 2021-09 makes two amendments to the risk-free discount rate practical expedient to address private entities' concerns and to clarify the expedient's application.

The first permits private entity lessees to elect the practical expedient by class of underlying asset, instead of on an all-or-nothing – i.e. all leases or no leases – basis. Private entity lessees are required to disclose their election of the practical expedient and the asset classes for which it has been elected.

**Observation:** This amendment permits a lessee to use its incremental borrowing rate for larger, lower volume leases (e.g. real estate leases), while using a risk-free rate for lower dollar, higher volume leases (e.g. office equipment). This may mitigate the balance sheet effect from electing the practical expedient, while still permitting a private entity lessee to elect it for most leases.

The second amendment clarifies that a lessee must use the rate implicit in the lease when it is readily determinable, even if the practical expedient has been elected for that class of underlying asset. The Board has reasoned that the rate implicit in the lease remains the rate that best reflects the economics of the lease and as such should continue to be used when it is readily determinable.

**Observation:** In practice, there are many inputs to determine the rate implicit in the lease, at least some of which are typically unavailable or unknown to the lessee. Therefore, the Board has indicated that it would not expect a lessee to have to undertake significant effort to demonstrate that the implicit rate is not readily determinable. By contrast, when those inputs are known, the rate is not difficult to calculate.

## Effective dates and transition methods

	Private entities
Annual periods – Fiscal years beginning after	December 15, 2021
Interim periods – Fiscal years beginning after	December 15, 2022
Early adoption permitted?	Yes, but no earlier than the entity's adoption of Topic 842

The available transition approaches depend on the entity's Topic 842 adoption status at November 11, 2021 – i.e. when the final ASU was issued.

- **Private entities that have not yet adopted Topic 842** adopt ASU 2021-09 at the same time and using the same transition method they use to adopt Topic 842 – either the effective date method or comparative method (see chapters 13A and 13B of KPMG Handbook, [Leases](#), respectively).
- **Private entities that have already adopted Topic 842** apply ASU 2021-09 on a modified retrospective basis to all leases that exist at the adoption date of the ASU's amendments through a cumulative effect adjustment to retained earnings at the beginning of their fiscal year.

Adjustments to a lease liability resulting from a change in the discount rate for the lease (e.g. from a risk-free rate to the lessee's incremental borrowing rate, or vice versa) in most cases will be recognized through a corresponding adjustment to the applicable ROU asset.

If a private entity has already adopted Topic 842, adopting these amendments does *not* trigger a reassessment of lease classification, the lease term or the remeasurement or reallocation of the consideration in the contract for affected leases.

### Contributing authors

Tim Hart, Scott Muir

### KPMG Financial Reporting View

[kpmg.com/us/frv](https://kpmg.com/us/frv)

This newsletter is part of our Defining Issues® collection of newsletters and articles with insights and news about financial reporting and regulatory developments.

Sign up [here](#) to receive news and insights delivered to your mailbox.

### [kpmg.com/socialmedia](https://kpmg.com/socialmedia)



© 2021 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent member firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. The KPMG name and logo are trademarks used under license by the independent member firms of the KPMG global organization.

The information contained herein is of a general nature and is not intended to address the circumstances of any particular individual or entity. Although we endeavor to provide accurate and timely information, there can be no guarantee that such information is accurate as of the date it is received or that it will continue to be accurate in the future. No one should act upon such information without appropriate professional advice after a thorough examination of the particular situation.