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DETERMINING AN INCREMENTAL BORROWING RATE FOR FOREIGN LEASES UNDER ASC 842

FASB ASC 842 guidance defines the incremental borrowing rate 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.”

For leases in denominated in foreign currencies, the similar economic environment is the country where the asset is in use. This paper will discuss how a practical method to determine an appropriate incremental borrowing rate for those foreign leases that meets the accounting requirements. For more information on determining an incremental borrowing rate for US denominated leases, please visit www.leasescre.com and download our whitepaper or click on the following link.

In order to account for the economic environment, the country risk needs to be accounted for. Borrowing rates in each country will start with the underlying government zero coupon yield curve. A company in country A will generally borrow at a rate that is greater than the rate that the country itself could borrow at. A zero coupon yield curve for a government is constructed based on government bonds, swaps, and other instruments like forward rate agreements. This yield curve represents the risks associated with inflation and default of the country among other economic factors.

It is important to start with the zero coupon yield curve for the country and then account for any lease or company specific factors that includes collateral, guarantees, financing concerns, and other factors that may influence the rate of interest to borrow. For many countries the liquidity of their foreign currency may be greater than the liquidity of various bonds and derivative instruments. The foreign currency exchange rate also accounts for inflation and country specific risks. The no arbitrage theory leads to Covered Interest Rate Parity (“CIRP”) which holds that you can’t borrow in one currency to buy government bonds in another currency and make risk free profits in the first currency. The formula below represents CIRP.

$$(1+i_s) = \frac{F_t}{S_t}(1+i_c)$$

This accounts for the risks between the two countries and should be the starting point for your incremental borrowing rate for foreign leases. Once you have the government yield curve for the country, you should then apply a credit spread, a collateral spread, and any lease or company specific spreads. We recommend proving CIRP holds to prove the government yield curve captures the risks in the similar economic environment. Analysis of traded bonds in the country may also prove helpful if available.

In conclusion, the practical method to determine an incremental borrowing rate for a foreign lease is to start with the zero coupon yield curve for the government in which the foreign lease resides and test that it meets covered interest rate parity. This is the starting point for your incremental borrowing rate which accounts for the economic environment. In order to estimate an incremental borrowing rate the zero coupon yield for the lease specific term requires additional spreads for credit, collateral, and lease or company specific risks or guarantees. This methodology meets the requirements under ASC 842 to determine an incremental borrowing rate.

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