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Pre-seen

Hotel Serene

Background

Amila Weerasinghe was born in 1963 as the youngest child in a wealthy family from southern Sri Lanka. He had three elder sisters. The family owned a tea plantation in Gampola, which was blessed with scenic natural beauty and included the existence of three waterfalls. Amila spent most of his school holidays in the estate with his siblings, and observed how most foreigners who were travelling to Nuwara Eliya stopped at the estate to see the natural waterfalls, which were a key attraction.

After completing his secondary education, Amila went to England in 1981 for further education in management studies. He spent nearly 10 years in the UK during which period he completed a Master's Degree in Business Management. Although he enrolled with the Institute of Chartered Accountants in England and Wales (ICAEW) as a student, he was not successful in getting through the examinations. Instead he worked in two restaurant chains where he gained thorough knowledge in the operation and management of restaurants. It was during this time he met Vidura Weerakoon who had also come to the UK for further studies. However Vidura was not very keen on studies and instead linked up with a tour operator in Sri Lanka to arrange European tours for Sri Lankan groups. This allowed Vidura to develop a good network of tour operators in the UK. He earned a quite a lot of money through this operation.

Amila and Vidura became good friends and resided at the same place during the latter part of their stay in the UK. They often discussed about their future plans, particularly the opportunities they would have if they returned to Sri Lanka. The duo gave thoughts to the possibility of setting up a good restaurant in Gampola to cater to the tourists travelling to and from Nuwara Eliya.

Evolution of Hotel Serene

In 1991 both Amila and Vidura returned to Sri Lanka with the idea of developing a business in Sri Lanka. Amila's father wanted him to take over the management of their tea estate, as his three sisters were not capable or interested in managing a plantation. Amila's father created a trust where the four siblings were the beneficiaries and the trustees, and transferred the tea estate to the trustees. Amila was entrusted with the management of the estate and distribution of profits among the beneficiaries.

Amila and Vidura identified a five-acre block in the estate surrounded by the three waterfalls and a series of mountains, and planned to build a hotel there called Hotel Serene. Amila made an arrangement for the trust to lease that particular block of five acres, and both he and Vidura invested money to construct a small luxury hotel. The hotel was opened in 1993, catering to foreign tourists as well as locals, and had five rooms, a restaurant and a bar at the start.

The hotel was initially operated as a partnership between Amila and Vidura, and they managed it by themselves with minimum staff. The restaurant soon became very popular among tourists passing by due to its motorable location and scenic beauty. The five guest rooms were also soon operating at full capacity. As a result in 2003 the property was expanded to include more rooms. Through a series of operating cycles with ups and downs the hotel thrived for a decade and established a good brand name and secured relationships with the community.

In 2005 Amila and Vidura converted the partnership into a private limited company, by the name 'Serene Leisure (Pvt) Ltd' after which the hotel took off on its jolting journey of growth. At this time a few of their friends also invested small sums of money. Amila and Vidura owned 90% of the shares in equal proportion, while the other shareholders owned 10%. Due to the magnitude of the expansion the company qualified for a 15-year tax holiday. After the end of the civil war in 2009, it was decided to list the company on the Colombo Stock Exchange. Accordingly it was listed on the Diri Savi Board as Serene Leisure PLC (SLP). SLP is the company that owns and operates Hotel Serene. Amila and Vidura are the major shareholders of the company, each with a 35% holding.

Amila always kept in mind his father's advice not to borrow money for expansion. Therefore he was very negative towards borrowing and did most of the expansions with ploughed back profits or fresh equity capital.

Management of the Hotel

With the listing of the company on the CSE, Amila and Vidura became the joint chairmen of the company. They invited three of their friends, who had made investments when the business became a private limited company, when it was listed on the CSE, to form the board subcommittees required by the continuing listing requirements of the CSE. One of them, who was a chartered management accountant, was appointed to chair all these board subcommittees. These three friends were not involved in the operational activities of the company.

Amila and Vidura continued to be closely involved with the operations of the company and most decisions were taken by the two of them. Whenever necessary they kept the other board members informed of their decisions. There was no necessity to hold meetings of the board or of the board subcommittees as Amila and Vidura were personally looking after all aspects of the hotel operations. Whenever there were statutory requirements, they informed the other directors over the phone and the secretary to the board regularised them through circular board resolutions. The other directors signed and approved the circular board resolutions with no questions being asked as they trusted and had faith in Amila and Vidura.

A manager who was looking after the day-to-day functioning of the hotel was appointed as the chief operating officer (COO). The assistant accountant who was maintaining the accounting records was appointed as the chief accountant and was also entrusted with the administration functions of the hotel. The COO and the chief accountant formed the senior management layer of the hotel, closely supervised by Amila and Vidura.

The auditor of the company used to report in their management letter about the lack of holding face-to-face meetings of the board and the board audit committee. Other matters referred to by the auditor included a lack of fire-fighting equipment and insurance for employees and third party liabilities.

Maintaining the minimum public float was a headache for SLP. The company secretary was frequently in touch with the CSE to buy time to comply with the minimum public float requirement. At times Amila and Vidura wondered whether the decision to list the company was a wrong one and even contemplated the possibility of de-listing the company.

Present Status

Hotel Serene has now been classified by most travel advisors as a 4-star boutique hotel located in the upcountry of Sri Lanka. Currently the hotel consists of 45 deluxe rooms and 5 family rooms. All the rooms are well equipped, clean, and spacious with amenities such as furniture, telephone, TV with satellite channels, ironing facilities, minibar, shower, and bathtub. The breathtaking surrounding view, with the cascading waterfalls and misty mountains, makes the whole experience at Hotel Serene a unique one.

Two spacious restaurants are available serving authentic Sri Lankan, Chinese, Western, Eastern and international cuisines, made with the gifted hands of talented chefs using fresh ingredients sourced from the local community. These restaurants overlook the beautiful scenery, providing customers a treat for their taste buds and eyes at the same time.

The hotel has a total of 50 employees with most of the lower tier staff being sourced from the local community. 75% of the staff cadre comprises young staff in the age group of twenties. Having the majority of the workforce being grown up in the millennial culture of moving fast in their careers in keeping with modern trends, has resulted the hotel with many advantages as well as disadvantages. The hotel engages in direct and indirect employment from the local community as means of both engaging with the local community and saving costs. Some school children in the neighbourhood would even come in the evenings and during school holidays to do a little work such as sweeping and cleaning the garden and watering the plants to earn some pocket money. This has led to great unity and collaboration within the workforce, as their relationships are not only limited to being co-workers, but also run as far as growing up in the same neighbourhood.

Operational Highlights

Hotel Serene has performed well during the last five years, recording an average occupancy rate of over 70%. Revenue for the financial year 2018/19 amounted to LKR 118 million with an operating profit of LKR 31 million. The restaurant and bar generate considerable revenue, as the hotel is popular as a stopover destination. Further, the hotel was able to maintain a GP margin around 60% and an operating margin around 30%, which are expected to improve in years to come.

With the expiration of the tax holiday and the new Inland Revenue Act implemented with effect from 1 April 2018, the profits from the hotel operation of SLP would be taxable at applicable rates.

The hotel has established internal controls to a certain extent such as attendance checks, bank reconciliations, cash disbursements and procurement procedures, while ensuring compliance with tax and other regulatory requirements. However, a recent incident occurred where a former employee of SLP was suspected of a misappropriation of funds amounting to LKR 5 million. The misappropriation had taken place at times when Amila and Vidura were not in the premises. Further investigations led to the matter being taken to courts. The case is still not finalised, and the amount of the misappropriation was written off during 2019/20.

The tourists patronising the hotel over the last three years have mainly been from China and the Middle East. This is because SLP had entered into contracts with a few tour operators in the aforementioned countries in order to bring traffic to the hotel.

Currently, the largest source of bookings for Hotel Serene is TripAdvisor. The COO of the hotel is of the view that more contracts should be signed with new tour operators for future growth and sustainability.

Surrounding of the Hotel

Hotel Serene is surrounded by waterfalls in the foreground and misty mountains in the background. Close proximity to world famous scenic waterfalls acts as a magnet to draw both local and foreign tourists to the region. The cool, calm and humid climate that prevails in the hill country add to the breathtaking scenery that is surrounded by mountains and waterways. The upcountry location of the hotel enables guests to enjoy the vast diversity that Mother Nature has gifted the island with that spans from the coasts to the mountainous region.

The wildlife that lurks within the grounds, the waves that surge the skies above are a treat for the eyes that make the unique experience at the hotel that much more worthy for guests. The geographical location of the hotel is strategically important, especially as the experience of the hotel is mainly tied with the experience of the natural beauty that surrounds the hotel.

Market and customers

Hotel Serene attracts a variety of customers, with the main segment being family. Currently, it is built around the concept of being the place for a family getaway that brings guests closer to nature with the comfort of man-made luxuries. The hotel is also popular amongst nature lovers and honeymooners, where the natural beauty and indulgence in nature acts as the sweet spot that attracts guests of all kinds.

The hotel engages in promotions via online travel agents and through its own website. More modern and easier promotions via social media have not drawn the attention of the management yet. Overall, the hotel has a bare minimum of digital presence due to the lack of competence of its staff. Engaging with customers mainly involves updating and managing the online travel agent (TripAdvisor) page for inquiries and comments on a daily basis, and regular guest face-to-face interactions by the executive staff of the hotel.

SLP has entered into a number of agreements with tour operators in various countries. Some of these tour operators obtain quotes and then decide prices in the currency of their own countries. In instances where there have been currency fluctuations, SLP has incurred losses due to the fluctuation of those currencies against hard currencies.

With a view to provide a wide range of experiences to the guests, the hotel has initiated the introduction of an adventure project. It also has plans to set up a new coffee shop near the waterfalls, and introduce village trekking and village lunch promotions. In addition to these new offerings, refurbishments and building of new rooms with modern facilities have also been planned. With all these facilities, the management of Hotel Serene is of the view that they could attract the stopover guests to stay with them.

Challenges faced by Hotel Serene

Being the scenic, attractive, geographical marvel it is, upcountry Sri Lanka is a popular tourist destination. This has resulted in the set-up of many establishments, such as Hotel Serene, that cater to tourists' needs. However, a decline in market share and industry overcapacity in a high growth competitive environment has posed a challenging situation for Hotel Serene to sustain in the market. Thus, the hotel has started to experience many challenges in its competitive environment.

Among these challenges, high priority is placed on attracting customers and retaining customer loyalty. With the increasing number of options available for the customers, with a range of facilities at different price levels, this challenge has become more and more difficult. Thus, the management strongly feels the need to offer a unique product coupled with outstanding service to customers, which would ultimately leave the target customer base of the hotel with no other option but to choose Hotel Serene.

At present, Hotel Serene is a familiar name in the region, having being in existence for more than 25 years. The prestige and brand name that it has built during this period has put it one step ahead of newcomers. Hotel Serene has also been able to secure exclusive deals in the supply chain due to the longstanding trust and relationship it has with its suppliers.

The locality of the hotel comprises of villages, which are mostly self-sustained and focused on agriculture. The climate favourable for cultivation that prevails in the region has resulted in the surrounding area being abundant with fresh, lush vegetation. This has also contributed to the everlasting beauty that surrounds the hotel area. Hotel Serene sources vegetables and other supplies it needs from local farmers, always ensuring that the ingredients they use for food is fresh. With the increase in hotels and restaurants that have popped up in the region, the village community has seen an increase in demand recently. In some cases this has resulted in suppliers resorting to cheaper ways of increasing output at the expense of quality.

However, being in operation for more than 25 years, Hotel Serene has managed to secure the loyalty of the local community to a certain extent. The fact that Amila's tea estate provides employment to many villagers has also helped in maintaining relationships. The hotel would help the school children in the neighbourhood with their education through the donation of books, clothing, school bags and shoes which also adds to this effort.

Amila and Vidura maintain regular face-to-face interactions with the community, and also give preference to youth from the community for employment in the hotel. These have strengthened the bond with suppliers.

Leisure Industry at Present

The leisure industry in Sri Lanka is highly competitive. The existence of boutique-type hotels, access to resources, minimum legal barriers, and increasing high-end customer requirements have made the industry highly competitive and difficult to sustain. Being a service provider, the main option for businesses in the leisure industry to be able to survive in the market is for them to offer a unique and high quality experience for their guests.

Evidently, for this to occur, there should be the perfect collaboration of views, location, access, service quality, activities etc. In addition to these, macro environmental factors such as the political stability of the country, national security, environmental practices and other factors all have a direct or indirect impact on the leisure industry.

The leisure industry of Sri Lanka was directly and seriously impacted by the Easter Sunday Attack that took place on 21 April 2019. Most of the tourism generating countries increased their travel advisories to the highest level, advising their citizens to avoid 'non-essential' travel to Sri Lanka. This resulted in a virtual cessation of tourist arrivals to the country. Occupancies in hotels dropped dramatically with many establishments recording zero, or near zero, occupancies.

Future Strategy

The Easter Sunday Attacks also adversely affected Hotel Serene, but it managed to operate above the cash breakeven level. Amila always said how they were able to minimise and sustain the impact, compared to other hotels, as they did not have a debt burden.

Amila and Vidura were keen on reviving and continuing the performance levels of the hotel in spite of the adverse impact created by the recent incidents. Due to a few landslides experienced in the area the authorities have ceased giving approvals for large-scale new constructions. Amila and Vidura consider this as a further opportunity to consolidate their position in the area. Accordingly they have requested the chief accountant to prepare a viable business plan for the future. Extracts of the draft sketch of the business plan prepared by the chief accountant is given in Annexure 1.

Recent developments

Despite the isolated incident that took place on Easter Sunday, the tourism authorities in Sri Lanka have pledged to resurrect the leisure industry sooner rather than later. The government has extended tax concessions and moratoria on debt to boost the motivation levels of entrepreneurs engaged in the leisure sector. Very recently Sri Lanka was ranked amongst the top most popular tourist destinations in the world. It is a nation with a very high level of hospitality, catering to a vast range of nationalities including Asians, Europeans and Americans. The existence of diverse climatic conditions, species, tea, food etc., and the unique hospitality of its people, has made Sri Lanka a must go destination for a traveler.

Being an island bound by the mesmerising blues of the Indian Ocean, Sri Lanka is gifted with natural beauty. This has been noticed and appreciated by people all over the world, making it an attractive destination not only for those who seek to enjoy the country's beauty, but also for those with a business mind and looking for attractive investment opportunities. The promising tourism industry of Sri Lanka has thus paved the way as an investment attraction for the development of the country as a whole.

Hotel Serene was recently approached by Green-Stone Fund Managers (Green-Stone), which manages several private equity funds focused on investments in South Asia. Green-Stone is a fund management entity based in Singapore and one of its Korean investors has expressed interest in Hotel Serene given its location. The investor believes that with the envisaged development in Sri Lanka resulting from more investments coming in, the hotel can enhance its operations to a much wider scale, thus generating the returns as well, in a similar scale.

Choeng Kanel, a fund manager at Green-Stone, recently visited Sri Lanka and made a site visit to Hotel Serene with Amila and Vidura. Subsequently the investor was interested in acquiring the hotel and Amila and Vidura were happy to consider a reasonable offer.

The investor was keen about the lease of the land and queried why it was not reflected in the balance sheet in the latest published annual report. He further asked the chief accountant how it would be included in the balance sheet and how the discount rate would be estimated in the absence of borrowings in the company. The chief accountant was unable to provide an instant answer but later obtained a write-up on the subject (see Annexure 2) from the auditor and passed it on to the investor.

Following the site visit and a few more discussions, the investor requested Choeng to obtain a valuation and get a specific scope due diligence exercise done for Hotel Serene.

Annexure 1

Current performance and forecast of SLP

	2018/19 Actual	**2019/20 Estimated**
Occupancy rate	70%	50%
Average room rate (USD)	55	45
Average exchange rate: 1 USD = LKR	160	180
Revenue (LKR '000)	112,420	73,913
Additional revenue from the bar and restaurant (LKR '000)	6,500	6,000
Total revenue (LKR '000)	**118,920**	**79,913**
Gross margin	65%	55%
Gross profit (LKR '000)	**77,298**	**43,952**
Administrative expenses (LKR '000)	(36,500)	(31,025)
Depreciation (LKR '000)	(1,825)	(1,825)
Marketing expenses (LKR '000)	(7,300)	(9,125)
Operating profit (LKR '000)	**31,673**	**1,977**
Assets and liabilities	LKR '000	LKR '000
Non-current assets	138,700	133,225
Current assets	40,150	32,850
Current liabilities	(29,200)	(24,820)
Non-current liabilities	(7,300)	(8,030)
Equity	142,350	133,225

Forecasted performance targets

	2020/21	2021/22	2022/23	2023/24	2024/25
Occupancy rate	64%	68%	72%	76%	80%
Average room rate (including food and beverage) (USD)	100	110	120	130	140
Average exchange rate 1 USD = LKR	180	180	180	180	180
Number of rooms	50	50	50	50	50
Additional revenue from the bar and restaurant (LKR '000)	6,570	7,884	9,198	10,512	11,826

Notes

- The average room rate includes food and beverage income from occupied rooms
- The occupancy targets have taken into consideration the additional facilities and attractions planned for guests
- A promotional drive has been planned with the restaurant to attract stopover guests, and this is expected to generate the additional revenue from the bar and restaurant

5-year forecast

	2020/21	2021/22	2022/23	2023/24	2024/25
Revenue (LKR '000)	210,240	245,718	283,824	324,558	367,920
Additional revenue from the bar and restaurant (LKR '000)	6,570	7,884	9,198	10,512	11,826
Total revenue (LKR '000)	**216,810**	**253,602**	**293,022**	**335,070**	**379,746**
Gross margin	60%	60%	60%	60%	60%
Gross profit (LKR'000)	**130,086**	**152,161**	**175,813**	**201,042**	**227,848**
Administrative expenses (LKR '000)	(41,975)	(48,271)	(55,512)	(63,839)	(73,415)
Depreciation (LKR'000)	(2,190)	(2,555)	(2,920)	(3,285)	(3,650)
Marketing expenses (LKR '000)	(10,841)	(12,680)	(14,651)	(16,754)	(18,987)
Operating profit (LKR '000)	**75,080**	**88,655**	**102,730**	**117,164**	**131,796**

Assumptions

- Gross margin will be 60% throughout the next five years
- Administrative expenses compared to 2018/19 will increase at 15% per annum
- Marketing expenses will be 5% of total revenue
- Depreciation forecast is arbitrary considering miscellaneous increases in fixed assets

Annexure 2
Discount Rate on Initial Recognition

All the components of the lease liability as described in Section 5.1. are required to be discounted to reflect the present value of the payments. The discount rate to use is the rate implicit in the lease, unless this cannot readily be determined, in which case the lessee's incremental borrowing rate is used instead.

The definition of the lessee's incremental borrowing rate states that the rate should represent what the lessee 'would have to pay to borrow over a similar term and with similar security, the funds necessary to obtain an asset of similar value to the right-of-use asset in a similar economic environment.' In applying the concept of 'similar security', a lessee uses the right-of-use asset granted by the lease and not the fair value of the underlying asset. This is because the rate should represent the amount that would be charged to acquire an asset of similar value for a similar period. For example, in determining the incremental borrowing rate on a 5 year lease of a property, the security for the portion of the asset being leased (i.e. the 5 year portion of its useful life) would be likely to vary significantly from the outright ownership of the property, as outright ownership would confer rights over a period of time that would typically be significantly greater than the 5-year right-of-use asset contained in the lease.

In practice, judgement may be needed to estimate an incremental borrowing rate in the context of a right-of-use asset, especially when the value of the underlying asset differs significantly from the value of the right-of-use asset.

An entity's weighted-average cost of capital ("WACC") is not appropriate to use as a proxy for the incremental borrowing rate because it is not representative of the rate an entity would pay on borrowings. WACC incorporates the cost of equity-based capital, which is unsecured and ranks behind other creditors and will therefore be a higher rate than that paid on borrowings. The use of WACC would therefore result in the carrying amounts of both lease liabilities and right-of-use assets being understated.

Use of rate of implicit in the lease vs. incremental borrowing rate

The rate implicit in the lease is the rate that would cause the present value of the lease payments and unguaranteed residual to equal the sum of the fair value of the underlying asset(s) and initial direct costs incurred. Using the implicit rate presents the true financing cost of leasing an asset as opposed to paying for it up-front or buying it outright without financing.

Allowing the incremental borrowing rate to be used acknowledges that a lessee is often not able to determine the implicit rate. A lessor often does not disclose the rate in the contract, or may offer a rate as being promotional (i.e. a below market interest rate), but also charge above-market lease rates to compensate for the low interest rate). Ultimately, to calculate the rate implicit in the lease requires not only information about the fair value of the leased asset at the start of the lease, but also its 'unguaranteed residual value' (the fair value at the end of the lease if the residual value is not being guaranteed). However, in many leases it will not be possible to make a reliable estimate of this, particularly where the lease term is less than the leased asset's useful economic life.

Therefore, it is likely that many lessees will use their incremental borrowing rate for a wide variety of leases.

Interest rate implicit in the lease for lease and non-lease components

If a lessee uses the interest rate implicit in the lease to measure leases (not the lessee's incremental borrowing rate), the lessee must also consider lease and non-lease components. While IFRS 16 contains a practical expedient that permits lessees to combine lease and non-lease components in the measurement of a lease contract (e.g. an automobile lease payment with built in maintenance services), in our view, lessees still must bifurcate these payments for purposes of determining the rate implicit in the lease. This is because the practical expedient (IFRS 16.15) permits lessees to not separate lease and non-lease components by accounting for them as a single lease component.

In determining the interest rate implicit in the lease, lessees must still comply with the definition, which states that it is the rate of interest that 'causes the present value of (a) the lease payments and (b) the unguaranteed residual value to equal the sum of (i) the fair value of the underlying asset and (ii) any initial direct costs of the lessor'. The term 'lease payments' is defined as 'payments made by a lessee to a lessor relating to the right to use an underlying asset…', meaning that the input into the determination of the rate implicit in the lease relates only to lease components, not non-lease components.

This creates additional complexity for entities using the rate implicit in the lease for the measurement of lease contracts.

Timing of the determination of the discount rate

The timing of the determination of the discount rate may affect lease measurement if there is a delay between contract inception and the commencement of the lease This can arise in situations where significant events occur between the inception and commencement dates, which would affect either the lessee's incremental borrowing rate or the rate implicit in the lease. For example, credit deterioration of the lessee would affect the incremental borrowing rate and significant geopolitical or technological events could affect the fair value of the underlying asset, which would in turn impact the rate implicit in the lease.

In our view, the determination of the discount rate from the lessee's perspective is at the commencement date of the lease, as IFRS 16.23 requires a lessee to measure the right-of-use asset at the commencement date. The applicable discount rate is a component of the measurement of the lease, therefore, it is determined at the same time as other components of the measurement of the lease.

For lessors, the guidance differs, as IFRS 16.66 states that lease classification between operating and finance type occurs at the inception date. The applicable discount rate is a component in determining how a lease is classified, as it affects the criteria used to analyse whether a lease is finance or operating. Consequently, the discount rate is determined at the inception of the lease contract for lessors.

Determining the incremental borrowing rate

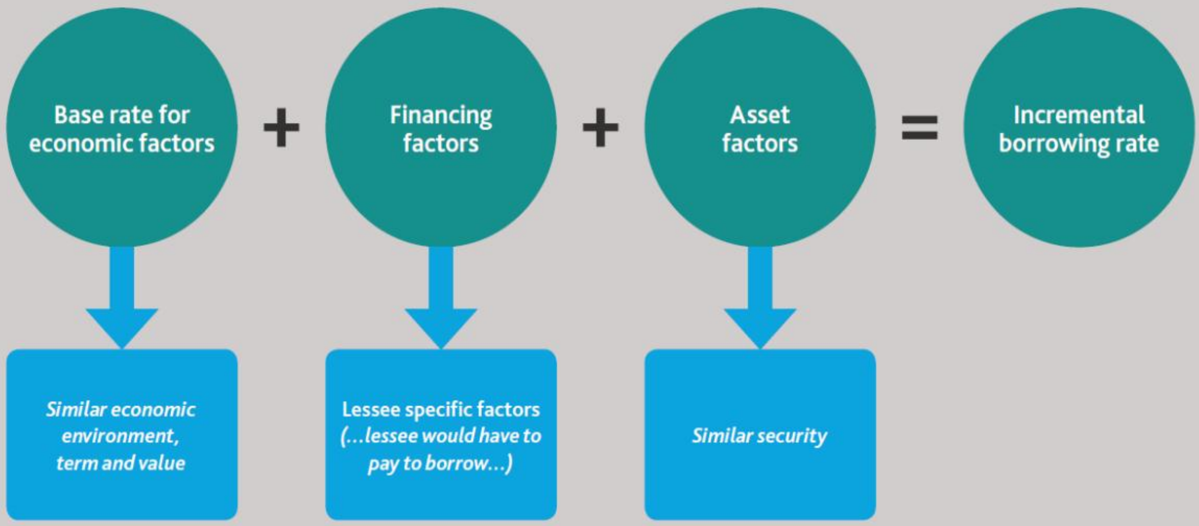
IFRS 16 does not contain significant guidance on how to determine the incremental borrowing rate beyond the definition provided (emphasis added):

> *'The rate of interest that a **lessee would have to pay to borrow** over a **similar term** and with **similar security**, the funds necessary to obtain an asset of **similar value** to the right-of-use asset in a **similar economic environment**.'*

In the absence of specific requirements in IFRS, preparers will have to apply judgment in determining the incremental borrowing rate. For entities with relatively small lease portfolios that are not material in the context of the entity's financial statements, then the work effort involved in determining the incremental borrowing rate for those leases may be lower. For entities with significant lease portfolios, the determination of the discount rate may have a very material impact on the statement of financial position as well as financial performance.

Determining the incremental borrowing rate is more complex than simply determining the weighted rate that an entity pays on its current borrowings. Such borrowings may have economic characteristic entirely dissimilar to the definition of the lessee's incremental borrowing rate as noted above.

In our view, the following methodology may provide a reasonable base for determining the incremental borrowing rate for a lease, as it incorporates the key elements denoted above in italics:



Base rate for economic factors: similar economic environment, term and value

The starting point in estimating the incremental borrowing rate is a 'base rate', which may be a risk-free rate derived from government bonds or other types of low risk financing. To achieve a 'similar economic environment', this rate should consider the applicable geographic location where the lessee operates. For example, the risk-free rate in the United States of America and sub-Saharan Africa would be very different.

The base rate should also consider the term of the lease, as risk-free rates differ depending on the period of time of the lending arrangement. For example, the risk-free rate for a 3-year lease of equipment would differ from the risk-free rate for a 20-year real estate lease, as the cost of borrowing tends to increase as the period of time increases.

An issue arises in developing this base rate, as there are often significant differences in the timing of cash flows between risk-free rates and leases. Low risk lending arrangements, such as government bonds, tend to have cash flows heavily weighted towards the end of the term (i.e. a 'bullet loan'). In some cases, all cash flows, including interest, may be deferred until this point in time. In contrast, most leases have period cash flows that occur over the lease term on a weekly, monthly, or annual basis. However, IFRS 16 does not contain specific guidance for the determination of the incremental borrowing rate.

At its September 2019 meeting, the IFRS Interpretations Committee (the Committee) issued an agenda decision in respect of determining the lessee's incremental borrowing rate. In its agenda decision, the Committee observed that an entity must apply judgment in determining its incremental rate of borrowing. The Committee observed that it would be consistent with the Board's objective for an entity to refer to readily observable rates for loans with similar payment profiles in developing the entity's incremental borrowing rate for a lease. Many lease contracts are amortising in nature with regular payments, meaning that an appropriate approach would be to use readily observable rates for loans that would also be amortising in nature (e.g. an amortising government bond with similar payment profile to the underlying lease).

One approach could be to use the yield curve for government bonds (which have a bullet repayment on maturity), with an appropriate rate being used to discount each of the lease payments. This would result in the determination of a 'base rate' which reflected the capital repayment profile of the lease.

An alternative approach which may be acceptable to account for this difference in the timing of cash flows (depending on the contractual payment terms of the lease) would be for entities to select reference bonds with cash flows that approximate the weighted cash flows for the underlying lease. For example, the rate attributable to a 10-year property lease with monthly cash flows may be satisfactorily represented by a 5-year bond with a bullet capital repayment on maturity. The weighted cash flows of the bond would be approximately 5-years. However, this may not always be an appropriate approach, for example where rates are low for the initial five year period but increase sharply for years five to ten.

Financing factors

IFRS 16 is clear that the intention of the discount rate guidance is to ensure the discount rate reflects how the contract is priced. As the 'base rate' discussed above represents a risk-free rate of borrowing, it must be adjusted to consider the credit risk of the entity. Entities may consider using readily observable rates for loans with similar payment profiles as a starting point.

Once an appropriate base rate is determined, it must be adjusted for characteristics of the lease that are dissimilar from the reference rate. This may be accomplished by obtaining credit spread information for the entity itself from recent borrowings; however, obtaining this information specific to one particular entity may be difficult in practice. Entities may also consider utilising industry data and making adjustments for the entity's specific credit risks relative to industry composites.

It should be noted that in group structures where central treasury functions obtain financing for groups across multiple jurisdictions, special considerations may apply. It is common for conglomerates and large corporate entities to centralise their borrowing function in order to lower borrowing costs for the group as a whole through economies of scale. In determining an appropriate incremental borrowing rate, entities must consider that it would generally not be appropriate to use a 'consolidated' borrowing rate for the group as a whole. This is because a group borrowing rate generally considers the blended credit characteristics of all entities in the group, which will normally differ from the terms of a lease obtained in each individual subsidiary. For example, a group treasury rate for a revolving credit facility may consider guarantees and diversification adjustments, which lower the rate for the group as a whole and not for each separate subsidiary. Upon consolidation of many entities within a corporate group, the incremental borrowing rate may differ significantly across different entities that operate in different geographic regions and industries, even if the underlying leased asset is similar.

Asset factors

In determining how the type of asset affects the incremental borrowing rate, entities should consider that a lease is in substance a 'secured loan', in that the lessor typically has recourse to repossess the underlying asset (which includes the lessee's right-of-use asset) if a lessee defaults.

IFRS 16 intends the incremental borrowing rate to represent the rate that would be charged to purchase the right-of-use asset. However, there are conceptual differences in achieving this in practice. For example, a lessor is typically exposed to residual value risk in leasing to an entity, which it would be expected to incorporate into the rate implicit in the lease. In our view, it would not be appropriate for the lessee to incorporate an asset risk premium for residual value risk because this is not consistent with the definition of the incremental borrowing rate. While the incremental borrowing rate and the rate implicit in the lease share many characteristics, exposure to residual value risk via an asset risk premium is not the same as security risk that a lender bears through the term of a borrowing arrangement.

In our view, it would still be appropriate to adjust the rate by a value that considers a borrower's view as to the risk of the type of asset that is being leased (e.g. the risk related to repossessing right-of-use assets for laptop computers compared to commercial office space would differ substantially). Significantly different costs would exist for these two examples, and the ability of a lender to realise a residual amount from the underlying collateral would differ substantially.

Example: Determination of Discount Rate for a Portfolio of Similar Leases

Note: this example illustrates the concepts discussed above in determining the discount rate for lease contracts. Additionally, this example illustrates how a lessee may make materiality decisions concerning the discount rate in measuring lease contracts. Such decisions must be made by management with appropriate analysis to support the simplifications used. The decisions noted below may not be appropriate to every entity; careful analysis of the facts and circumstances in each case is required.

Entity L is a new freight and logistics firm that has entered into a large number of leases for railcars in order to transport its customers' goods. It has also entered into a number of leases for smaller equipment such as automobiles and forklifts. The interest rate implicit in the leases is not readily determinable, therefore, Entity L will discount the lease liability upon initial recognition of the leases using its incremental borrowing rate. In determining the discount rate to apply to the total portfolio of leases, Entity L elects to utilise the practical expedient to apply IFRS 16 to a portfolio of leases with similar characteristics.

Entity L's major lease portfolio consists of two major types of railcars: heavy rail and light rail, therefore, Entity L will determine the discount rate for these portfolios of leases separately. These portfolios are hereafter referred to as the 'heavy portfolio' and 'light portfolio'. The smaller equipment lease portfolio (e.g. automobiles and forklifts) is referred to as the 'minor equipment portfolio'.

For all leases, Entity L will make quarterly payments in advance of equal amounts over the related lease term.

Entity L applies the methodology discussed in the previous section to determine the discount rate for these three portfolios.

Example: Determination of Discount Rate for a Portfolio of Similar Leases (continued)

Base rate for economic factors: similar economic environment, term and value

Heavy portfolio

Entity L analyses its portfolio of leases and notes that the lease terms vary between 4 and 6 years, with the leases being evenly dispersed over that period (in number and value). Consequently, Entity L concludes that the weighted average lease term is 5 years.

Entity L then reviews interest rates applicable to high quality bonds in its jurisdiction and notes that:

- The bonds pay interest quarterly and have 'bullet' capital repayments on maturity (in contrast to the lease liabilities which are amortising balances);
- Interest rates for bonds with maturities of between 1 and 5 years rise evenly over the 4 year period.

Consequently, Entity L concludes that a reasonable approximation of the 'base' rate will be obtained by referring to the interest rate for bonds with a 2.5 year duration. Utilising instruments with a duration equal to 50% of the weighted average lease term accounts for the fact that the referenced bonds are bullet loans with 'back loaded' cash flows compared to the cash flows of the lease, which are evenly dispersed. The base rate is determined to be 3.10%.

If the lease portfolio had been different, then additional analysis would have been required. For example, Entity L might have found that while the average lease term is 5 years, there are a significant number of leases in this portfolio with lease terms of 18 months-2 years compared to another large number of leases with terms of 7-8 years. While the applicable reference bonds for these more granular segments carry different interest rates, Entity L would need to carry out a sensitivity analysis to determine whether the use of a single 2.5 year reference rate would potentially have a material impact in the measurement of the lease contracts.

In addition, if an approximation is used, it is necessary to revisit the approach as and when additional leases are added in future to determine whether the approximation remains acceptable.

Light portfolio

Entity L performs an analysis similar to above, noting that the average lease term in the light portfolio is 3 years. The applicable rate after referencing a series of high quality bonds in the applicable jurisdiction is 2.65%.

Minor equipment portfolio

The minor equipment portfolio is made of many different types of equipment with various lease terms ranging from 1 to 4 years, with lease terms and values evenly spread in this range. Entity L notes that the minor equipment portfolio is immaterial in comparison to its railcar portfolios and to the financial statements as a whole Consequently, Entity L considers that it is acceptable to use a 3.00% discount rate for the minor equipment portfolio of lease contracts, rather than determining different rates for various sub-portfolios of different types of equipment with different lease terms. Entity L performs a sensitivity analysis and notes that a reasonably possible shift in the discount rate would not result in a material difference in the measurement of this portfolio. Although financing factors are also considered, an adjustment for asset factors is not considered necessary as its effect would be immaterial.

Financing factors

Heavy portfolio

To adjust the base rate for credit risk factors, Entity L refers to the spread between the credit rating of bonds in the reference portfolio compare to Entity L's own credit risk. The credit rating for the bonds in the reference portfolio were AAA, meaning they have a low risk of defaulting on the payments. Entity L consults with several banks in its jurisdiction and obtains a number of different interest rate 'spreads' between AAA borrowers and Entity L for loans of 2.5 years in duration. The average of these spreads is 1.75%.

Light portfolio

Entity L performs an analysis similar to above, however, for a reference portfolio with an average duration of 1.5 years (i.e. half of the light portfolio's weighted average lease term). The average of these spreads is 1.25%.

Minor equipment portfolio

Entity L considers the range of lease terms in this portfolio and the credit spreads for the heavy and light portfolios. It concludes that a reasonable approximation of the credit spread applicable to the minor equipment portfolio is 1.50%.

Asset factors

Heavy portfolio

The base rate and credit spread determined above relate to an unsecured borrowing position. Entity L notes that the security in its leases are the underlying right-of-use asset, therefore, an adjustment to the borrowing rate should take this into account. Entity L consults with several banks on the adjustment to the rate on a secured borrowing position. Entity L notes that in discussions with banks, they note that the underlying asset provides less relevant security than say, commercial real estate in a major city centre, since realising on the underlying security (rail cars) is more difficult and would include more significant costs. The adjustment for the asset factors is -0.45%.

Light portfolio

Entity L performs an analysis similar to above, however, the nature of the security (light rail cars) differs slightly. The banks that Entity L consults that light rail cars are used less frequently and have shorter useful lives, therefore, the nature of the security provides a lower adjustment than the heavy portfolio. The adjustment for the asset factors is -0.35%.

Minor equipment portfolio

Entity L performs an analysis similar to that of the heavy portfolio. As the minor equipment has a relatively short useful life, Entity L believes the adjustment for asset factors is minor. The adjustment for asset factors is -0.10%.

Conclusion

Combining the relevant factors together results in the following discount rates:

Heavy portfolio	=	base rate + financing factors + asset factors
Heavy portfolio	=	3.10% + 1.75% + (-0.45%)
Heavy portfolio	=	4.40%
Light portfolio	=	base rate + financing factors + asset factors
Light portfolio	=	2.65% + 1.25% + (-0.35%)
Light portfolio	=	3.55%
Minor equipment portfolio	=	base rate + financial factors
Minor equipment portfolio	=	3.00% + 1.50% + (-0.10%)
Minor equipment portfolio	=	4.40%