No. 2023-03
29 March 2023

To the Point

FASB — final guidance

FASB issues leases guidance for arrangements between entities under common control

The final guidance addresses stakeholder feedback received during the post-implementation review of ASC 842.

What you need to know

- The FASB amended ASC 842 to provide a practical expedient that allows private companies and certain not-for-profit entities to use the written terms and conditions of a common control arrangement to determine whether a lease exists and to classify and account for the lease.
- A lessee or lessor that applies the practical expedient is not required to evaluate whether the written terms and conditions of the arrangement are legally enforceable.
- The amendments also require all lessees, including public business entities, to amortize leasehold improvements associated with common control leases over their useful life to the common control group and account for them as a transfer of assets between entities under common control at the end of the lease.
- Additional disclosures are required when the useful life of leasehold improvements to the common control group exceeds the related lease term.
- The guidance is effective for fiscal years beginning after 15 December 2023, including interim periods within those fiscal years. Early adoption is permitted.

Overview

The Financial Accounting Standards Board (FASB or Board) amended Accounting Standards Codification (ASC) 842, *Leases*, to give private companies and certain not-for-profit entities the flexibility to use the written terms and conditions of a common control arrangement, rather than the legally enforceable terms, to determine whether a lease exists and to classify and account for the lease.

Building a better working world

The Accounting Standards Update (ASU) also amends ASC 842 to require all lessees, including public business entities, to amortize leasehold improvements associated with common control leases over their useful life to the common control group. At the end of the lease, a lessee is required to account for the leasehold improvements as a transfer of assets between entities under common control, meaning they would adjust equity (or net assets for not-for-profit entities).

This guidance addresses concerns raised by private companies and not-for-profit entities during the post-implementation review of ASC 842.

Key considerations

Practical expedient to use written terms and conditions

The new guidance allows entities other than public business entities, not for-profit conduit bond obligors or employee benefit plans that file or furnish financial statements with the Securities and Exchange Commission to use the written terms and conditions of a common control arrangement to determine whether a lease exists and to classify and account for the lease. The practical expedient can be elected on an arrangement-by-arrangement basis.

An entity that applies the practical expedient is not required to evaluate whether the written terms and conditions are legally enforceable. However, if no written terms and conditions exist (or the practical expedient is not elected), an entity is required to determine the legally enforceable terms and conditions of the common control arrangement and use them to evaluate whether a lease exists and to classify and account for the lease.

ASC 842 previously required all entities, including those entering into arrangements with entities under common control, to determine whether a lease existed based on the legally enforceable terms and conditions of the contract. If a lease existed, all lessees and lessors classified and accounted for it on the basis of the legally enforceable terms and conditions.

Private companies expressed concerns that determining the legally enforceable terms and conditions in common control arrangements may be challenging and may require assistance from legal counsel because such terms and conditions are often unwritten or lack sufficient detail.[1]

Transition

Entities that adopt this ASU concurrently with adopting ASC 842 are required to apply this portion of the ASU using the same transition method used to adopt ASC 842. An entity that elects the "package of practical expedients"[2] as part of adopting ASC 842 is not required to apply those expedients to common control arrangements for which the entity elects to use the written terms and conditions to determine whether a lease exists and to classify and account for the lease.

Entities that adopt this ASU after they have adopted ASC 842 can apply this portion of the ASU either (1) prospectively to arrangements that commence or are modified on or after the date that the entity applies the new guidance or (2) retrospectively to the beginning of the period ASC 842 was first applied for arrangements that exist at the date of adoption of this ASU.

When electing this practical expedient, entities are permitted to document existing unwritten terms and conditions of common control arrangements before the date on which the entity's first interim (if applicable) or annual financial statements are available to be issued.

In the year of adoption, entities are required to provide certain transition disclosures under ASC 250 based on the transition method elected.

How we see it

If an entity applies the practical expedient and concludes that a common control arrangement is not a lease (i.e., ASC 842 does not apply), we believe that other GAAP generally does not permit the entity to capitalize improvements to an asset controlled by another party.

Lessee amortization of leasehold improvements

The new guidance requires all lessees in a lease with a lessor under common control, including public business entities, to:

- Amortize leasehold improvements over their useful life to the common control group, as long as the lessee controls the use of the underlying asset through a lease
- Account for the leasehold improvements as a transfer of assets between entities under common control through an adjustment to equity (or net assets for not-for-profit entities) when the lessee no longer controls the use of the underlying asset

Public and private company lessees are required to amortize leasehold improvements associated with common control leases over their useful life to the common control group.

If after the commencement date the lessee and lessor become part of the same common control group or stop being part of the same common control group, a lessee would account for any change in the required amortization period for leasehold improvements prospectively as a change in accounting estimate under ASC 250, *Accounting Changes and Error Corrections*.

Lessees are also required to apply the impairment guidance in ASC 360-10-40-4 to leasehold improvements associated with common control leases.

ASC 842 previously required a lessee to amortize leasehold improvements over the shorter of the remaining lease term or the useful life of the improvements. However, if ownership of the underlying asset transferred to the lessee or the lessee was reasonably certain to exercise a purchase option at the end of the lease term, leasehold improvements were amortized over their useful life.

Private companies indicated that, in some cases, a common control lease may have a short lease term (e.g., one year) as well as associated lessee-owned improvements that have a useful life to the common control group life that far exceeds the lease term. These stakeholders expressed concerns that in these cases, fully amortizing leasehold improvements over a period shorter than the useful life to the common control group (as previously required by ASC 842) may result in financial reporting that does not reflect the economics or the common control nature of those improvements.[3]

The Board believes that leasehold improvements associated with common control leases are generally made at the direction of the common owner(s) and are expected to benefit the group rather than just the lessee. This makes common control leases economically different from leases between entities that are not under common control.[4]

Disclosures

When the useful life of leasehold improvements to the common control group exceeds the lease term, a lessee is required to disclose the unamortized balance of the leasehold improvements at the balance sheet date, their remaining useful life to the common control group and the remaining lease term.

Transition

Entities that adopt this ASU concurrently with adopting ASC 842 may apply this portion of the ASU using the same transition method used to adopt ASC 842, or they may apply one of the prospective methods described below.

Entities that adopt this ASU after adopting ASC 842 may apply this portion of the ASU using one of the following methods:

- Prospectively to all new leasehold improvements recognized on or after the date an entity first applies the new guidance
- Prospectively to all new and existing leasehold improvements recognized on or after the date an entity first applies new guidance, with the remaining balance of existing leasehold improvements amortized over their remaining useful life to the common control group (i.e., in a manner similar to a change in accounting estimate)
- Retrospectively to the beginning of the period in which ASC 842 was first applied, with any leasehold improvement amortization or impairment that would not have been required by this ASU recognized through a cumulative-effect adjustment to opening retained earnings (or net assets of a not-for-profit entity) at the beginning of the earliest period presented

In the year of adoption, lessees are required to provide certain transition disclosures under ASC 250 based on the transition method elected.

Effective date

This ASU is effective for all entities for fiscal years beginning after 15 December 2023, including interim periods within those fiscal years. Early adoption is permitted for financial statements that have not been made available for issuance in any interim or annual period as of the beginning of the related fiscal year.

Endnotes:

[1] Basis for Conclusion (BC) 14 in the ASU.

[2] As part of adopting ASC 842, lessees and lessors are permitted to apply a package of practical expedients that allows them to not reassess the following for any expired or existing leases: whether contracts are or contain leases, lease classification and whether initial direct costs qualify for capitalization. Entities are also permitted to use hindsight when determining lease term and assessing right-of-use assets for impairment (842-10-65-1(f) through (g)).

[3] BC 24 in the ASU.

[4] BC 27 in the ASU.