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# FASB Issues Guidance on Common-Control Lease Arrangements

## Introduction

On March 27, 2023, the FASB issued [ASU 2023-01](#),<sup>1</sup> which amends certain provisions of ASC 842<sup>2</sup> that apply to arrangements between related parties under common control. Specifically, the ASU:

- Offers private companies, as well as not-for-profit entities that are not conduit bond obligors, a practical expedient that gives them the option of using the written terms and conditions of a common-control arrangement when determining whether a lease exists and the subsequent accounting for the lease, including the lease's classification (Issue 1).
- Amends the accounting for leasehold improvements in common-control arrangements for all entities (Issue 2).

## Issue 1: Practical Expedient That Allows the Evaluation of Written Terms and Conditions of a Common-Control Arrangement

ASC 842 requires entities to determine whether a related-party arrangement between entities under common control is a lease on the basis of the legally enforceable terms and conditions of the arrangement. The accounting for a lease depends on the enforceable rights and obligations of each party as a result of the contract. This principle applies irrespective of whether such rights or obligations are included in the contract or explicitly or implicitly provided outside of the contract (i.e., there may be enforceable rights or obligations that extend beyond the written lease contract).

<sup>1</sup> FASB Accounting Standards Update (ASU) No. 2023-01, *Leases (Topic 842): Common Control Arrangements*.

<sup>2</sup> FASB Accounting Standards Codification Topic 842, *Leases*.

As part of the FASB's postimplementation review of ASC 842, private companies asserted that this requirement creates unnecessary cost and complexity for financial statement preparers, since the terms and conditions of such common-control lease arrangements may lack sufficient details, may be uneconomic, or may be changed without approval, given that one party in the common-control group generally controls the arrangement. Therefore, stakeholders have indicated that it is challenging to determine the legally enforceable terms and conditions of these arrangements and that legal counsel may need to be involved in making this determination, thereby incurring additional cost.

In response to that feedback, the ASU provides an optional practical expedient under which private companies, as well as not-for-profit entities that are not conduit bond obligors, can use the written terms and conditions of an arrangement between entities under common control to determine (1) whether a lease exists and (2) the subsequent accounting for (and classification of) the lease. This practical expedient can be applied on an arrangement-by-arrangement basis, and an entity is not required to consider the legal enforceability of such written terms and conditions. However, if no written terms and conditions of an arrangement between entities under common control exist, an entity is not allowed to elect the practical expedient and is required to apply ASC 842 in a manner consistent with how it is applied to other arrangements.



### Connecting the Dots

Although the FASB considered whether this practical expedient should be available to all entities, it ultimately decided to limit its application to private companies and not-for-profit entities that are not conduit bond obligors because public registrants have already adopted ASC 842 without raising concerns related to arrangements between related parties under common control.

## Issue 2: Accounting for Leasehold Improvements in Common-Control Arrangements

Under ASC 842, a lessee is generally required to amortize leasehold improvements that it owns over the shorter of the useful life of those improvements or the lease term.

As part of the FASB's postimplementation review of ASC 842, some stakeholders stated that leasehold improvements associated with leases between entities under common control are economically different from those associated with leases between entities not under common control. In lease arrangements between entities not under common control, leasehold improvements made by the lessee can either be for the lessee's own benefit or for the benefit of the lessor. However, leasehold improvements made under leases between entities under common control are expected to benefit the parties under the common-control arrangement. Therefore, private-company stakeholders have noted that, in a lease arrangement between entities under common control, the amortization requirements of ASC 842 are inconsistent with the underlying economics of the arrangement, since (1) the lessee may continue to control the use of the underlying asset after the lease term and (2) another party in the common-control group may benefit from the leasehold improvements after the lessee no longer controls the use of the underlying asset.

In response to that feedback, the ASU requires a lessee in a common-control lease arrangement to amortize leasehold improvements that it owns over the improvements' *useful life*<sup>3</sup> to the common control group, regardless of the lease term, if the lessee continues to control the use of the underlying asset through a lease.

<sup>3</sup> This represents a change from the proposed ASU, which stated that leasehold improvements associated with common-control leases should be amortized over the economic life of the leasehold improvements rather than their useful life. The FASB made the change primarily because (1) the amortization period should be limited to the period in which the common-control group can direct the use of the underlying asset, (2) amortizing the leasehold improvements over the useful life to the common-control group would be consistent with the period used by a lessee when applying the impairment guidance in ASC 360, and (3) it could be challenging for a lessee to determine the economic life of a leasehold improvement since it may be required to consider factors outside the common-control group in such circumstances.

In situations in which a lessee obtains control of an underlying asset through a lease with an unrelated party not under common control and subsequently subleases the asset to an entity under common control, the sublessee would generally amortize the leasehold improvements over a period that does not exceed the term of the lease between the lessee/intermediate lessor and the unrelated party. However, if the lease between the lessee/intermediate lessor and the unrelated party contains an option to purchase the underlying asset and the lessee/intermediate lessor is reasonably certain to exercise that option, the leasehold improvements should be amortized over the useful life to the common-control group.

Further, a lessee that no longer controls the use of the underlying asset will account for the transfer of the underlying asset as an adjustment to equity (i.e., as with a transfer of assets between entities under common control).



### Connecting the Dots

Unlike Issue 1, Issue 2 applies to all entities. The FASB believes that Issue 2 is more pervasive and that all entities are currently applying multiple methods to account for leasehold improvements in leases between related parties under common control. For example, according to the FASB, some entities are accounting for these leasehold improvements by (1) amortizing them over the shorter of the lease term or the useful life of the leasehold improvements, (2) amortizing them over the lease term to an estimated salvage value and accounting for the unamortized balance as a transfer between entities under common control at the end of the lease term, or (3) amortizing them over the lease term with a portion recognized as a lease payment.

Accordingly, the FASB's objective is to eliminate this diversity in practice by requiring both public and private entities to apply the amendments in Issue 2.

## Adoption and Transition

### Effective Date

ASU 2023-01 is effective for fiscal years beginning after December 15, 2023, including interim periods within those fiscal years. Early adoption is permitted in any annual or interim period as of the beginning of the related fiscal year.

### Issue 1

Entities that have not adopted ASC 842 on or before the effective date of ASU 2023-01 must apply the transition requirements of ASU 2016-02.<sup>4</sup> Entities that have adopted ASC 842 before the effective date of ASU 2023-01 can apply the amendments in either of the following ways:

1. Prospectively to arrangements that commence or are modified on or after when the entity first applies ASU 2023-01.
2. Retrospectively to the beginning period in which an entity applied ASC 842 for arrangements that existed as of the adoption date of ASU 2023-01. The practical expedient cannot be applied to common-control arrangements that no longer exist as of the adoption date.

In addition, ASC 842-10-65-7(d) states, in part, that “[a]n entity may document any existing unwritten terms and conditions of an arrangement between entities under common control before the date on which the entity's first interim (if applicable) or annual financial statements are available to be issued.”

<sup>4</sup> FASB Accounting Standards Update No. 2016-02, *Leases (Topic 842)*.

## Issue 2

Entities that have not adopted ASC 842 on or before the effective date of ASU 2023-01 may apply the transition requirements of ASU 2016-02. However, entities that elect to retrospectively apply ASU 2016-02 to the beginning period of adoption are allowed to apply either of the prospective approaches described below to avoid retrospectively accounting for leasehold improvements associated with common-control leases.

Entities that have adopted ASC 842 before the effective date of ASU 2023-01 have the option of using one of the following adoption methods:

1. Prospective application to all new leasehold improvements recognized on or after the date that the entity first applies the amendments in ASU 2023-01.
2. Prospective application to all new and existing leasehold improvements recognized on or after the date that the entity first applies the amendments in ASU 2023-01, with any remaining balance of leasehold improvements amortized over their remaining useful life to the common-control group determined as of that date.
3. Retrospective application to the beginning of the period in which an entity first applied ASC 842, with any leasehold improvements that otherwise would not have been amortized or impaired recognized through a cumulative-effect adjustment to opening retained earnings at the beginning of the earliest period presented in accordance with ASC 842.

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