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FASB Proposes Amendments to Guidance on Common-Control Lease Arrangements

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Introduction

On November 30, 2022, the FASB issued a [proposed ASU](#)¹ that would amend certain provisions of ASC 842² that apply to arrangements between related parties under common control. Specifically, the proposed ASU would:

- Offer 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).
- Amend the accounting for leasehold improvements in common-control arrangements for all entities (Issue 2).

Comments on the proposed ASU are due by January 16, 2023.

¹ FASB Proposed Accounting Standards Update (ASU), *Leases (Topic 842): Common Control Arrangements*.

² FASB Accounting Standards Codification (ASC) Topic 842, *Leases*.

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).

Private companies have 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 asserted that determining the legally enforceable terms and conditions of these arrangements is challenging and could necessitate involving legal counsel, thereby incurring additional cost.

In response to that feedback, the FASB voted unanimously to give private companies, as well as not-for-profit entities that are not conduit bond obligors, a practical expedient to use the written terms and conditions of an arrangement between entities under common control to determine whether a lease exists and the subsequent accounting (including classification) of the lease. This practical expedient could be applied on an arrangement-by-arrangement basis, and an entity would not be 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 would not be allowed to elect the practical expedient and would be 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.

Some stakeholders believe 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 stated that applying the amortization requirements of ASC 842 to leases between entities under common control would be inconsistent with the underlying economics of the arrangement because (1) the lessee will continue to control the use of the underlying asset after the lease term or (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 FASB voted 4-3 to require a lessee in a common-control lease arrangement to amortize leasehold improvements that it owns over the *economic life*³ of those improvements, regardless of the lease term, if it continues to control the use of the underlying asset through a lease. 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 must 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. Further, a lessee that no longer controls the use of the underlying asset will account for the transfer of the 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. Although only private entities provided feedback on Issue 2, the FASB believes that this issue 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) accounting for the improvements as variable lease payments when the lessee makes the improvements.

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

Issue 1

Entities that have not adopted ASC 842 on or before the effective date of a final ASU would apply the transition requirements of ASU 2016-02.⁴ Entities that have adopted ASC 842 before the effective date of a final ASU 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 the final ASU.
2. Retrospectively to the beginning period in which an entity applied ASC 842 for arrangements that existed as of the adoption date of a final ASU.

Regardless of which transition method the entity chooses, it would be allowed to “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” when adopting the amendments.

Issue 2

Entities that have not adopted ASC 842 on or before the effective date of a final ASU would apply the transition requirements of ASU 2016-02. However, entities that elect to retrospectively apply ASU 2016-02 to the beginning period of adoption would be allowed to apply its amendments prospectively by using either of the prospective approaches described below.

³ As explained in paragraph BC26 of the proposed ASU, in referring to lease arrangements between entities under common control, the FASB considered it more appropriate to use the term “economic life” of leasehold improvements rather than “useful life,” since “economic life” is not limited to entity-specific (that is, lessee-specific) assumptions about how an entity intends to use an asset.”

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

Entities that have adopted ASC 842 before the effective date of a final ASU would have the option of using one of the following adoption methods:

1. Prospectively to all new leasehold improvements recognized on or after the date that the entity first applies the amendments in the final ASU.
2. Prospectively to all new and existing leasehold improvements recognized on or after the date that the entity first applies the amendments in the final ASU, with any remaining balance of leasehold improvements amortized over their remaining economic life determined as of that date.
3. Retrospectively to the beginning of the period in which an entity applied ASC 842 for leasehold improvements that exist as of the date of adoption of a final ASU, with any leasehold improvements that otherwise would not have been amortized recognized through a cumulative-effect adjustment to opening retained earnings at the beginning of the fiscal year of adoption.

An entity would be required to apply the amendments related to both Issue 1 and Issue 2 in interim periods within the fiscal year of adoption.

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