FASB Finalizes Common Control Lease Relief

On March 27, 2023, FASB issued the eagerly awaited Accounting Standards Update (ASU) 2023-01, Common Control Arrangements, that addresses two issues:

- Terms and conditions to be considered for arrangements between entities under common control in determining whether a lease exists, and if so, the classification and accounting for that lease
- The accounting for leasehold improvements under Accounting Standards Codification (ASC) 842 when the lease term in a common control lease is shorter than the **useful** life of the leasehold improvements

Early adoption of this ASU is permitted for both interim and annual financial statements that have not yet been made available for issuance.

Effective Dates
ASU 2023-01

All Entities
Fiscal years beginning after December 15, 2023

For a detailed review of ASC 842 requirements, see "ASC 842, Leases: July 2022 Update."

Background

ASC 842 updated ASC 840's requirements for related-party leases. ASC 842 requires entities to classify and account for related-party leases based on an arrangement's **legally enforceable** terms and conditions (consistent for leases between unrelated parties). ASC 840 required entities to classify and account for related-party leases based on the arrangement's **economic substance** when transaction terms were significantly affected by the fact that the lessee and lessor are related. FASB initially concluded that determining the economic substance of arrangements between related parties often was not practicable because terms and conditions, if any, between the parties may not be consummated at arm's length and noted that in certain situations, *e.g.*, month-to-month arrangements, legally enforceable terms and conditions may not exist.

ASC 840	ASC 842
Lessees and lessors must consider **economic substance** • Required significant judgment in some circumstances • Resulted in diversity in practice • Some preparers imputed market terms	Lessees and lessors must classify and account for leases between related parties on the basis of **legally enforceable** lease terms and conditions • Treated in the same manner as leases between unrelated parties

Challenges

Legal Enforceability

In many common control arrangements, lease contracts can be made verbally, and lease terms may be explicit or implicit outside of a formal lease contract, *e.g.*, a management or operating agreement may create enforceable rights and obligations related to leases without specifically contemplating those leases.

Private companies have consistently highlighted that arrangements between entities under common control often are unwritten or lack sufficient detail, and arrangement terms and conditions may be uneconomic or not aligned with other related transactions or agreements. In these cases, private companies are concerned that they are required to determine whether implicit legally enforceable terms and conditions exist, which may require legal counsel. FASB outreach indicates that auditors also have seen diversity in practice in the extent of diligence that an entity is expected to undertake to evaluate the legal enforceability of written terms and/or identify implicit terms in common control arrangements.

Leasehold Improvements

If a lessee adds significant leasehold improvements or the underlying asset is integral to the lessee's operations, *e.g.*, a customized production facility, considering whether implicit lessee renewal rights exist to determine the lease term could impact the recognition and amortization of those leasehold improvements.

The amortization period for leasehold improvements depends on whether ownership of the leased asset transfers to the lessee at the end of the lease term or the lessee is reasonably certain to exercise a purchase option. If either condition is met, the leasehold improvement should be amortized over its useful life. In other lease arrangements, a leasehold improvement should be amortized over the shorter of its useful life or the remaining lease term. As ASC 842 was originally drafted, it would be inappropriate to conclude the amortization period for a leasehold improvement exceeds the lease term.

FASB research indicated there also was diversity in practice on how leasehold improvements in leases with entities under common control were accounted for, and highlighted the following methods that were acceptable under previous GAAP:

- Amortizing leasehold improvements in full over the shorter of the leasehold improvements' lease term and useful life
- Amortizing leasehold improvements over the lease term to an estimated salvage value with the unamortized balance accounted for as a transfer between entities under common control at the end of the lease term
- Accounting for the improvements as a lease payment

I. Terms & Conditions to Be Considered for Arrangements Between Entities Under Common Control

ASU 2023-01 creates a new practical expedient for related-party arrangements between entities under common control. The practical expedient may be applied on an arrangement-by-arrangement basis. If elected, in determining if a lease exists, an entity would consider whether written terms and conditions convey the **practical right** to control the use of an identified asset for a period of time in exchange for consideration. **An entity would not be required to determine whether those written terms and conditions are legally enforceable.** If an entity determines that a lease exists, the lease should be classified and accounted for based on those written terms and conditions.

Applying the practical expedient does not eliminate the need for an entity to apply other relevant guidance in ASC 842. For example, an entity would still be required to determine whether an arrangement contains lease and nonlease components.

If no written terms and conditions exist, an entity is prohibited from applying the practical expedient and would continue to apply the existing ASC 842 requirements. That is, an entity would need to consider legally enforceable terms and conditions (oral and implicit) for purposes of determining whether a lease exists and, if so, the associated classification and accounting of a lease. Consistent with ASC 842, if no legally enforceable terms and conditions exist, the arrangement would not be a lease and other GAAP would apply.

The ASU includes guidance for when the practical expedient is elected and entities are subsequently no longer under common control:

- If the arrangement was previously a lease and continues to be a lease, the entity shall classify and account for the lease on the basis of the enforceable terms and conditions. If the enforceable terms and conditions differ from the written terms and conditions previously used to apply ASC 842, an entity would use the modification guidance in ASC 842. If the enforceable terms and conditions are the same as the written terms and conditions, the modification requirements are not applicable.
- If the arrangement was previously not determined to be a lease and is determined to be a lease, the arrangement would be accounted for as a new lease.
- If the arrangement was previously determined to be a lease and the lease ceases to exist:
  - A lessee shall apply the modification requirements for fully terminated leases
  - A lessor with a lease previously classified as a sales-type lease or a direct financing lease shall apply the derecognition requirements for terminated leases
  - A lessor with a lease previously classified as an operating lease shall derecognize any amounts that would not exist if the arrangement was not accounted for as a lease and account for the arrangement in accordance with other GAAP

Scope

The ASU generally applies only to private companies and certain nonprofits (NFPs), specifically entities other than the following:

- Public business entities (PBEs)
- NFP conduit bond obligors
- Employee benefit plans (EBPs) that file or furnish financial statements with or to the SEC

Transition

Entities that adopt ASC 842 concurrently with ASU 2023-01 would follow the same transition requirements used to apply ASC 842.

Entities that already adopted ASC 842 would be allowed to apply the practical expedient in this ASU either:

- Prospectively to arrangements that commence or are modified on or after the date that the entity first applies the practical expedient, or

- Retrospectively to the beginning of the period in which the entity first applied ASC 842 for arrangements that exist at the date of adoption of the practical expedient. The practical expedient does not apply to arrangements no longer in place at the adoption of ASU 2023-01.

Regardless of the transition approach, an entity is permitted to document any existing unwritten terms and conditions of a common control arrangement before the date on which the entity's first interim (if applicable) or annual financial statements are available to be issued in accordance with the practical expedient in this ASU.

II. Accounting for Leasehold Improvements (Lessee Only)

The ASU amends ASC 842 to require that leasehold improvements for leases between entities under common control be:

- Amortized over the improvement's **useful life to the common control group** (regardless of the lease term) as long as the lessee controls the use of the underlying asset through a lease. If the lessor obtained the right to control the use of the underlying asset through a lease with another entity not within the same common control group, the amortization period may not exceed the amortization period of the common control group
- Accounted for as a transfer between entities under common control through an adjustment to equity (net assets for an NFP entity) when the lessee no longer controls the use of the underlying asset

If after the commencement date the lessee and lessor become within the same common control group or are no longer within the same common control group, any change in the required amortization period for leasehold improvements shall be accounted for prospectively as a change in accounting estimate in accordance with ASC 250, Accounting Changes and Error Corrections.

Impairment

Impairment guidance in ASC 360, Property, Plant, and Equipment, would apply to the leasehold improvements associated with leases between entities under common control. A long-lived asset (asset group) should be tested for recoverability while it is held and used using estimates of future undiscounted cash flows based on the asset's remaining useful life to the common control group.

Applying this impairment guidance effectively prohibits a lessee under common control from transferring leasehold improvements that would be immediately impaired by the receiving entity.

Disclosures

When the useful life of leasehold improvements to the common control group exceeds the related lease term, a lessee shall disclose the following information:

- The unamortized balance of the leasehold improvements at the balance sheet date
- The remaining useful life of the leasehold improvements to the common control group
- The remaining lease term

Scope

These amendments would apply to all entities (PBEs, private companies, NFPs, and EBPs) that are lessees in common control leases in which there are leasehold improvements.

Transition

Entities adopting ASU 2023-01 concurrently with ASC 842 may follow the same transition requirements used to apply ASC 842 or may elect to use either of the prospective approaches described below.

An entity that has already adopted ASC 842 would be allowed to apply ASU 2023-01 using one of the following methods:

- Prospectively to all new leasehold improvements recognized on or after the date that the entity first applies ASU 2023-01
- Prospectively to all new and existing leasehold improvements recognized on or after the date that the entity first applies ASU 2023-01, with any remaining unamortized balance of existing leasehold improvements amortized over their remaining useful life to the common control group determined at that date
- Retrospectively to the beginning of the period in which the 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 the opening balance of retained earnings at the beginning of the earliest period presented in accordance with ASC 842

Effective Date & Early Adoption

The effective date for both issues will be for fiscal years, including interim periods, beginning after December 15, 2023. Early adoption is permitted in any annual or interim period for which financial statements have not yet been made available for issuance. If an entity adopts the amendments in an interim period, it must adopt them as of the beginning of the fiscal year that includes that interim period.

Conclusion

For some entities, ASC 842's adoption will be complex and likely will require significant hours to implement correctly. **FORVIS** can help educate your team, provide implementation tools, and assist with analysis and documentation. If you would like assistance complying with the new guidance, contact us.

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