BDO BULLETIN

FASB ADDRESSES LEASE ACCOUNTING ISSUES ASSOCIATED WITH COMMON CONTROL ARRANGEMENTS

MARCH 2023

SUMMARY

The accounting for leases between entities under common control is changing. Specifically, the new guidance includes the following provisions:

- Nonpublic entities[1] can elect a practical expedient to use the written terms and conditions of their arrangements between entities under common control ("common control arrangements") to determine whether a lease exists and, if so, to classify and account for that lease, rather than using legally enforceable terms and conditions as currently required.
- All entities (public or nonpublic) will be required to amortize leasehold improvements associated with leases between entities under common control ("common control leases") generally over the useful life of the leasehold improvements to the common control group, rather than over the shorter of the useful life of those leasehold improvements and the remaining lease term as currently required.

Transition for the new guidance, issued by the FASB in ASU 2023-01[2] (the "ASU") varies; nonpublic entities, especially those finalizing their adoption of ASC 842 should consider the effects of this ASU.

BACKGROUND

Private company stakeholders raised concerns about ASC 842 application to common control arrangements (such as arrangements between sister entities controlled by a common owner). The following table summarizes the original ASC 842 requirements and related concerns.

---

[1] Includes entities that are not: public business entities (as defined in U.S. GAAP), not-for-profit entities that have issued or are conduit bond obligors for securities that are traded, listed, or quoted on an exchange or an over-the-counter market or employee benefit plans that file or furnish financial statements with or to the U.S. Securities and Exchange Commission.

[2] *Leases (ASC 842): Common Control Arrangements*

ORIGINAL ASC 842 REQUIREMENTS	CONCERNS RAISED
Entities must determine whether a related party arrangement, including a common control arrangement, is or contains a lease based on the legally enforceable terms and conditions of the arrangement. If a lease exists, entities also are required to classify and account for that lease based on those enforceable terms and conditions.	Private companies adopting ASC 842 said it was challenging to determine whether the terms and conditions in common control arrangements are legally enforceable because the common control arrangements may be unwritten and, even when written, may be amended or not enforced by the common owner.
Lessees must amortize leasehold improvements[3] over the shorter of the useful life of those improvements and the remaining lease term (except when title to the underlying asset transfers to the lessee or the lessee is reasonably certain to exercise a purchase option).	Common control leases often have a short lease term (for example, one year), even if the lessee makes significant leasehold improvements with an estimated useful life significantly longer than the lease term (for example, 10 years). According to private company stakeholders, amortizing the significant leasehold improvements over the lease term does not result in economically faithful information when the lessee and lessor are under common control because the common control group benefits from the improvements, either by extending the lease with the lessee after the expiration of the initial lease or by transferring the assets to the lessor or another entity within the common control group.

The ASU amends the guidance in ASC 842 to address those two issues.

BDO INSIGHTS

The FASB did not address the following issues:

- How to assess and account for related party arrangements other than common control[4] arrangements. Stakeholders did not raise significant concerns about those arrangements, which are evaluated based on legally enforceable terms and conditions.
- The definition of common control. Similar to its decisions in some previous projects, the FASB noted that the term “common control” is used in other areas of U.S. GAAP. The FASB observed that an entity may refer to the SEC staff’s observations in Emerging Issues Task Force (EITF) Issue 02-5, *Definition of “Common Control” in Relation to FASB Statement No. 141*, acknowledging that private companies and most not-for-profit entities may apply a broader definition of common control. We believe that an entity should apply the term “common control” consistently as an accounting policy election. Also, at a minimum, we believe common control arrangements include arrangements in which a controlling financial interest exists, as defined in ASC 810, *Consolidation*.
- Which party to the common control lease is the owner of improvements made to a leased asset. The FASB acknowledged that various reasonable approaches exist in practice and, therefore, decided not to provide guidance in the ASU.[5]

[3] Leasehold improvements generally constitute improvements made by a lessee to the underlying leased asset for which the lessee is determined to be the accounting owner and are recognized on a lessee’s balance sheet.
[4] Basis for Conclusions (BC) 10 and BC11 of the ASU.
[5] BC40 of the ASU.

MAIN PROVISIONS

Terms and Conditions to be Considered

The ASU provides nonpublic entities a practical expedient to use the written terms and conditions of a common control arrangement to determine whether a lease exists and, if so, to classify and account for that lease. Under the practical expedient, an entity assesses whether the written terms and conditions convey the practical right (rather than an enforceable right) to control the use of an identified asset for a period of time in exchange for consideration to determine whether a lease exists. If so, the entity classifies and accounts for the lease based on those written terms and conditions. The practical expedient may be applied on an arrangement-by-arrangement basis.

If no written terms and conditions exist, the entity cannot apply the practical expedient and it must use the enforceable rights and obligations to apply ASC 842 to the common control arrangement, like any arrangement between unrelated parties or related parties not under common control. However, as a part of transition, an entity may document the unwritten terms and conditions of existing common control arrangements. Such documentation must be completed before the entity's first interim or annual financial statements in which the ASU is first applied are available to be issued.

The following concepts are also important:

- Whether the entity applies the practical expedient or not, if the common control arrangement is not a lease, the entity applies other U.S. GAAP to account for both the arrangement and any improvements made by the customer to the supplier's asset. That is, improvements are recognized on a customer/lessee's balance sheet as leasehold improvements only when the arrangement is or contains a lease.[6]
- Applying the practical expedient does not eliminate the need for an entity to apply other relevant guidance in ASC 842 if the common control arrangement is or contains a lease. For example, an entity is still required to determine whether the arrangement contains lease and non-lease components or to evaluate the lease term if there are lessee options to extend or not terminate the lease.

If, after applying the practical expedient, the common control relationship changes such that an arrangement is no longer between entities under common control, an entity uses the enforceable rights and obligations to determine whether a lease exists and follows the relevant accounting approach discussed below:

Arrangement previously was a lease and continues to be a lease	▶ Classify and account for the lease based on enforceable terms and conditions ▶ If the enforceable terms and conditions differ from the written terms and conditions previously applied under the practical expedient, apply modification accounting
Arrangement previously was not a lease and is determined to be a lease	▶ Account for the arrangement as a new lease at the date of the change in the common control relationship
Arrangement previously was a lease and is no longer a lease	▶ Apply lease termination accounting, which depends on whether the entity is the lessee or lessor and, for a lessor, on classification of the lease

BDO INSIGHTS

When using the transition relief described above, private entities should document the terms and conditions of common control arrangements that were in effect and considered in applying ASC 840, *Leases*. Any revision to those terms and conditions that change the scope of the lease or the consideration for the lease should be accounted for as modifications (at the effective date of such modification), rather than as part of the adoption of ASC 842.

[6] BC16 and BC24 of the ASU.

Nonpublic entities that elect to apply the practical expedient may need to set up new processes to periodically ASU the common control arrangement to make sure they can continue to use the expedient. For example, if the written terms and conditions are for a short lease term (e.g., a one-month or a one-year lease), and those written terms and conditions expire, the entity will not be able to use the practical expedient and will need to evaluate the legally enforceable terms and conditions, like any other lease between unrelated parties or related parties not under common control.

Also, if the written terms and conditions allow the lessee to extend the one-month or the one-year lease at its option, or if the lease continues unless terminated by either party and the lessee would incur a significant penalty to terminate the lease (for example, because it would lose the benefit of significant leasehold improvements), the guidance in ASC 842 on determining the lease term applies, which may result in a lease term for accounting that is longer than the stated term.

The FASB decided not to prescribe the documentation requirements necessary to use the practical expedient.[7] Rather, entities can use reasonable judgment to determine how terms and conditions of an arrangement are conveyed in writing. Therefore, we believe that a written document does not need to meet the legal definition of a contract to qualify for the practical expedient. For example, an email documenting the written terms and conditions of the arrangement may suffice, even if it does not include other clauses that generally appear in a legal contract.

Accounting for Leasehold Improvements

The ASU states that:

- A lessee amortizes leasehold improvements associated with a common control lease over the useful life of those improvements to the common control group, regardless of the lease term, if the lessee controls the use of the underlying asset through a lease. If the lessor obtained the right to control the underlying asset's use through a lease with another entity outside the common control group, then the amortization period cannot exceed the amortization period of the common control group determined in accordance with ASC 842-20-35-12.
- If the lessee loses control of the use of the leased asset to another entity in the common control group, the remaining balance of leasehold improvements is accounted for as a transfer between entities under common control through an adjustment to equity (or net assets for a not-for-profit entity).

While the FASB received concerns about the requirements in ASC 842 mostly from private company stakeholders, it concluded that these changes better reflect the economics of leasehold improvements in common control leases and therefore the changes apply to all entities.

In response to the changes discussed above, the FASB also clarified that leasehold improvements associated with common control leases are:

- Not considered lease payments.
- Assessed for impairment by applying the guidance in ASC 360, *Property, Plant and Equipment*, for long-lived assets to be exchanged or distributed to owners in a spinoff, considering the improvements' useful life to the common control group.[8]

After a lease's commencement date, any change in the amortization period for leasehold improvements because of a change in a common control relationship is accounted for prospectively as a change in accounting estimate.

[7] BC22 of the ASU.

[8] ASC 360-10-40-4

BDO INSIGHTS

Unlike the practical expedient on evaluating terms and conditions of a lease, the guidance on amortization and transfers of leasehold improvements applies to both public and nonpublic entities. This means that:

- Public entities that have adopted ASC 842 may need to make changes to existing processes, systems, or controls to comply with this new guidance.
- Public and nonpublic entities need to identify changes to common control relationships after a lease's commencement date on a timely basis, and account for the resulting change for the leasehold improvements prospectively. Entities should consider whether they need to specifically track information or other events in their lease system that are not otherwise monitored for lease accounting.

DISCLOSURES

The ASU requires lessees to provide the following disclosures when the useful life of leasehold improvements to the common control group exceeds the related lease term:

- 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

Additionally, entities must consider the disclosure requirements in ASC 850, *Related Party Transactions*, to provide users of financial statements with sufficient information to analyze an entity's common control arrangements.

EFFECTIVE DATES AND TRANSITION

The ASU is effective for public and nonpublic entities in fiscal years, including interim periods within those fiscal years, starting after December 15, 2023. Early adoption is permitted for all entities in any annual or interim period as of the beginning of the related fiscal year.

Terms and Conditions to Be Considered (Nonpublic Entities Only)

STATUS OF ASC 842 ADOPTION	TRANSITION METHOD
Entities that have not yet adopted ASC 842	Same transition method elected to apply ASC 842. Also, the practical expedient in this ASU can be elected separately from other transition practical expedients for those common control arrangements.
Entities that have already adopted ASC 842	Either: ▶ Prospectively to arrangements that commence or are modified after the date that the entity first applies the practical expedient ▶ Retrospectively to the beginning of the period when 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 common control arrangements no longer in place at the adoption date of the ASU

Accounting for Leasehold Improvements (All Entities)

STATUS OF ASC 842 ADOPTION	TRANSITION METHOD
Entities that have not yet adopted ASC 842	Either: ▶ The same transition method used to apply ASC 842 ▶ One of the prospective approaches described below
Entities that have already adopted ASC 842	Any of the following: ▶ Prospectively to all new leasehold improvements recognized on or after the date that the entity first applies the ASU ▶ Prospectively to all new and existing leasehold improvements recognized on or after the date that the entity first applies the ASU, 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 for leasehold improvements that exist at the adoption date of the ASU, 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 adoption date of ASC 842

The ASU is available here.

* * * * *

CONTACT

Thomas Faineteau
Professional Practice Principal, Accounting
tfaineteau@bdo.com

Angela Newell
Professional Practice Principal, Accounting
ajnewell@bdo.com

Bobbi Gwinn
Professional Practice Director, Accounting
bgwinn@bdo.com