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Center for Plain English Accounting

AICPA's National A&A Resource Center

FASB ASC 842
Leasehold Improvements at Transition & Related Party Leases Update

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As entities prepare to recognize operating leases for the first time on the balance sheet under FASB *Accounting Standards Codification* (FASB ASC) 842, *Leases,* questions are increasing about the treatment of associated leasehold improvements. The new lease standard in FASB ASC 842 generally is consistent with the old lease standard in FASB ASC 840, with the same title, with respect to leasehold improvement amortization. Specifically, at FASB ASC 842-20-35-12,

> Leasehold improvements shall be amortized over the shorter of the useful life of those leasehold improvements and the remaining lease term, unless the lease transfers ownership of the underlying asset to the lessee or the lessee is reasonably certain to exercise an option to purchase the underlying asset, in which case the lessee shall amortize the leasehold improvements to the end of their useful life.

However, the old lease standard at FASB ASC 840-10-35-6 did have a notable difference which was not carried forward to FASB ASC 842 with respect to leasehold improvements in operating leases that are placed in service significantly after and not contemplated at or near the beginning of the lease term. For those leasehold improvements amortization was over the shorter of:

1. The useful life of the leasehold improvements
2. A term that includes required lease periods and renewals that are deemed to be reasonably assured (as used in the context of the definition of lease term) at the date the leasehold improvements are purchased

Accordingly, under FASB ASC 840, it was possible to have a lease term for the leased asset that was shorter than the amortization period for the associated leasehold improvement. Under FASB ASC 842 the amortization period for leasehold improvements cannot be longer than the lease term for the leased asset (FASB ASC 842 leasehold amortization guidance noted above). However, the transition guidance in FASB ASC 842 did not specify how to account for leasehold improvement amortization periods that are longer than the associated leased asset lease term that existed upon transition to FASB ASC 842 (as a result of the guidance in FASB ASC 840-10-35-6).

In the Basis for Conclusion (BC), paragraph 390 of Accounting Standards Update (ASU) 2016-02, the FASB indicated that "entities will, in effect, 'run off' existing leases." Accordingly, it would appear reasonable to conclude by analogy that the FASB did not intend for entities to shorten existing leasehold improvement amortization periods at the transition date of FASB ASC 842 even if that period was greater than the lease term for the associated leased asset at that date.

Given the lack of transition guidance in ASU 2016-02 and the FASB's intentions expressed in BC 390 with respect to existing lease accounting at the transition date, we think that two alternatives exist to account for leasehold amortization periods that differ from the lease term associated with the leased asset (because of FASB ASC 840-10-35-6) for purposes of transitioning to FASB ASC 842. In our view, those two alternatives are only applicable if an entity does NOT elect the hindsight practical expedient for lease term under FASB ASC 842-10-65-1(g). We also think that the alternatives are an accounting policy election which should be consistently applied.

1. Retain existing leasehold improvement amortization period. That is, continue amortizing the leasehold improvements over that period unless the lease is discontinued. The lease would generally be considered discontinued if the entity did not exercise a renewal option.
2. Reduce the leasehold improvement amortization period to match the associated right of use asset lease term and recognize a transition adjustment through equity. Effectively, that adjustment would catch up leasehold improvement amortization so that, at the effective date of FASB ASC 842, the remaining leasehold improvement amortization would reflect the balance which would have existed if the lease term for the associated leased asset had always been used for amortization purposes.

EXAMPLE:

On January 1, 2018, Entity A enters in to a 5-year lease for office space with Lessor. Entity A has a contractual option to renew the lease for 5 additional years. Lessor and Entity A are unrelated parties. Entity A determines at lease inception that the 5-year renewal option is not reasonably assured within the meaning of FASB ASC 840 (changed to reasonably certain in FASB ASC 842). Accordingly, the lease term for the office space is 5 years under FASB ASC 840. At June 30, 2021, Entity A places in service new leasehold improvements in the office space with a value of $100,000 that were not contemplated at the beginning of the lease term. Based on the guidance in FASB ASC 840-10-35-6, Entity A determines that it is now reasonably assured to exercise the 5-year renewal option. Therefore, in accordance with FASB ASC 840-10-35-6, the amortization period for those leasehold improvements placed in service June 30, 2021 includes the 5-year renewal period and is 6.5 years (useful life of leasehold improvements is longer than 6.5 years). Based on FASB ASC 840, Entity A does not update the lease term for the classification and accounting for the office space lease. Accordingly, the remaining lease term at June 30, 2021 is 1.5 years. At January 1, 2022, Entity A adopts FASB ASC 842 with the package of 3 practical expedients under FASB ASC 842-10-65-1(f) but does not elect the hindsight practical expedient under FASB ASC 842-10-65-1(g). How are the existing leasehold improvements addressed at the January 1, 2022 transition date?

> Alternative #1 -- Entity A does not change the leasehold improvement amortization period. At January 1, 2022 the unamortized leasehold improvement balance of $92,308 continues to be amortized over the remaining 6-year lease term.
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> Alternative #2 -- Entity A recognizes a transition adjustment to equity to align the leasehold improvement amortization period with the remaining lease term on the office space lease of 1 year. When adopting FASB ASC 842 on January 1, 2022, the unamortized leasehold improvement balance of $92,308 is adjusted to $66,667 through a $25,641 transition adjustment to equity. The remaining balance of $66,667 is amortized over the remaining year of the lease term (assuming no subsequent reassessment of lease term under FASB ASC 842-10-35-1).

We have informally discussed our view above with the FASB Staff who is aware that both alternatives are currently accepted in practice if an entity does not elect the hindsight practical expedient for lease term under FASB ASC 842-10-65-1(g). We also note our Alternatives are consistent with interpretative approaches on the question at hand in Deloitte's Roadmap: Leases (November 2021), pg. 743-744.

CPEA Observation*:* The views above apply to leasehold improvements at the transition date for both related party leases and unrelated party leases. We discuss below current standards setting activity, including a tangential matter related to leasehold improvements, which are restricted to related parties under common control.

Updates on Related Party Leases Under Common Control

In February, we wrote about accounting for related party leases under common control providing an overview of interpretations under FASB ASC 842. Since then, questions have continued as well as concerns about legal consultation.

In response to those continued questions and concerns, on September 14, 2022, the FASB held an education session on the issue. On September 21, 2022, the FASB added a project to its technical agenda to address arrangements between entities under common control and made tentative decisions on the following two issues:

Issue #1 -- What terms and conditions an entity should consider for:

Determining whether a lease exists and, if so,

The classification and accounting for that lease

Issue #2 -- Accounting for leasehold improvements associated with leases between entities under common control

Tentative Board Decisions

Issue #1

For arrangements between entities under common control, the FASB tentatively decided to amend FASB ASC 842 to provide entities within the scope of FASB ASC 842-10-65-1(b) (that is, entities that are not public business entities, not-for-profit bond obligors, or employee benefit plans that file or furnish financial statements with or to the U.S. Securities and Exchange Commission) a practical expedient to use written terms and conditions for:

Determining whether a lease exists and, if so,

The classification and accounting for that lease

An entity applying the practical expedient would not be required to determine whether those written terms and conditions are legally enforceable. If no written terms and conditions exist, an entity would apply FASB ASC 842 on the basis of the legally enforceable terms of an arrangement. If an entity determines that a lease does not exist, other U.S. Generally Accepted Accounting Principles (U.S. GAAP) would apply. The FASB also tentatively decided that the practical expedient could be applied on an arrangement-by-arrangement basis.

Practice Note: Conduit debt obligor not-for-profits and public business entities (including non-SEC registrant public business entities) would NOT be within the scope of that practical expedient and would need to continue to apply FASB ASC 842 on the basis of legally enforceable terms of an arrangement.

Issue #2

The FASB tentatively decided to amend FASB ASC 842 for all entities with leases between entities under common control to specify that a lessee should account for associated leasehold improvements as follows:

> Amortize leasehold improvements over the economic life of the improvements as long as the lessee continues to use the underlying asset. If the lessor obtained the underlying asset through a lease with an entity not under common control, the economic life over which the leasehold improvements are amortized by the lessee should not exceed the lease term associated with the lessor's lease with the entity not under common control.
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> Account for any remaining leasehold improvements as a transfer between entities under common control if, and when, the lessee ceases using the underlying asset.
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> The FASB tentatively decided that a lessee should disclose information about leases in which the economic life of the leasehold improvements is longer than the lease term.

CPEA Observation: Several FASB members noted the existing guidance on related party leases under common control may be unclear on whether leasehold improvement amortization over the lease term would amortize a leasehold improvement fully or to an estimated salvage value which will be transferred to a common control related party. Accordingly, at present, we think that either view is acceptable and the tentative decision represented a clarification on the matter.

Timing of Final ASU?

The FASB directed the staff to draft a proposed ASU for vote by written ballot, with a comment period of 45 days.

IMPORTANT NOTE: **All decisions reached at the September 21, 2022 meeting were tentative and may change upon further deliberations. Changes to U.S. GAAP are only effective with a final ASU.**

Based on discussions with the FASB Staff, they will attempt to promptly issue a final ASU after seeking and considering public comment. However, changes from the tentative decision based on the FASB's decision-making process are possible. We will continue to monitor and report on these developments.

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