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FASB ASC 842

Exposure Draft on Common Control Arrangements

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On November 30, 2022, FASB issued an Exposure Draft Lease (Topic 842), *Common Control Arrangements*, to attempt to resolve pressing questions on the application of FASB *Accounting Standards Codification* (FASB ASC) 842, *Leases*, to leases (or potential leases) between related parties under common control. Those questions pertain to the decision in FASB ASC 842 that related party leases should be applied “on the basis of legally enforceable terms and conditions of the arrangement.” (ASU 2016-02, BC 374). In this report, we will discuss FASB’s potential solutions for questions about related party leases under common control in FASB ASC 842. We also will discuss our observations on the Exposure Draft.

We are reporting on this Exposure Draft since practitioners have expressed high degrees of interest in this issue and implementation of FASB ASC 842 is imminent.

Our February [report](#), *Related Party Leases: Overview of Interpretations under FASB 842*, noted that, “[w]hile the FASB intended to simplify related party lease accounting, the shift from economic substance in FASB ASC 840 to legally enforceable terms and conditions in FASB ASC 842 has given rise to more questions.”

Questions on the application of FASB ASC 842 to related parties under common control appeared to reach a crescendo at the [AICPA Engage Conference](#) in June 2022 and we noted that both FASB and FASB staff began to take higher levels of interest in resolving application of FASB ASC 842 to related parties under common control.

FASB’s Response

The Exposure Draft has two main provisions. First, it provides a practical expedient for private companies and not-for-profit entities that are not conduit debt obligors to use written terms and conditions to determine if a lease exists in common control arrangements, and if a lease exists, the accounting and classification for that lease

(hereinafter referred to as the “written terms and conditions practical expedient”). Second, it addresses a corollary issue around the amortization period for leasehold improvements for related party leases under common control which is proposed to apply to all entities.

Issue 1- Written Terms and Conditions Practical Expedient

The practical expedient provides that qualifying entities:

[S]hall use the written terms and conditions of a related party arrangement between entities under common control to determine whether that arrangement is or contains a lease. For purposes of determining whether a lease exists under this practical expedient, an entity shall determine whether written terms and conditions convey the practical (as opposed to legally enforceable) right to control the use of an identified asset for a period of time in exchange for consideration. If an entity determines that a lease exists, that entity shall classify and account for that lease on the basis of those written terms and conditions.

The practical expedient would be permitted to be applied on an arrangement-by-arrangement basis. The Exposure Draft also notes that, if no written terms or conditions exists, an entity would not be able to apply the practical expedient and would need to determine whether a lease exists based on existing FASB ASC 842-10-15-3. If a lease is determined to exist based on FASB ASC 842-10-15-3, entities would classify and account for that lease on the basis of “its legally enforceable terms and conditions in accordance with [FASB ASB] 842-10-55-12.” Therefore, entities with unwritten related party arrangements under common control may need legal consultation to identify implied legally enforceable terms and conditions.

Practice Note: The use of the phrase “written terms or conditions” is not intended to necessarily require formalized lease documents and could include informal written documentation. It appears that the FASB intended for entities and practitioners to use judgment.

The exposure draft does, however, permit an entity 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.”

CPEA Observation: The Exposure Draft does not define “common control” which is not currently defined in the FASB ASC. Basis of Conclusion (BC) 7 in the Exposure Draft does note the “Board believes that the term *common control* should be broader for private companies and not-for-profit entities than what the SEC staff observed in [EITF] Issue 02-5.” (emphasis in the original)

Entities that have not yet adopted FASB ASC 842 on or before the effective date of a final ASU would follow the transition requirements of ASU 2016-02, *Leases (Topic 842)*, for the amendments in the Exposure Draft using the same transition method elected to apply FASB ASC 842.

For entities that have adopted FASB ASC 842 before the effective date of a final ASU, an entity would be allowed to apply the amendments in this Exposure Draft either:

1. Prospectively to arrangements that commence or are modified on or after the date that the entity first applies the proposed amendments
2. Retrospectively to the beginning of the period in which the entity first applied FASB ASC 842 for arrangements that exist at the date of adoption of a final ASU. The Exposure Draft would not be applicable for arrangements no longer in place at the date of adoption of a final ASU

Issue 2- Accounting for Leasehold Improvements

A follow-on issue regarding related party leases under common control relates to the amortization period for leasehold improvements. Under FASB ASC 842-20-35-12, leasehold improvements are generally amortized over the shorter of the useful life of those leasehold improvements and the remaining term. Accordingly, if a written lease term for related parties under common control is very short term, does that limit the amortization period of leasehold improvements?

To address this question, the FASB proposed that leasehold improvements associated with a lease between entities under common control shall be:

- a. Amortized over the economic life of those improvements as long as the lessee controls the use of the underlying asset through a lease. If the lessor obtained the right to control the underlying asset through a lease with another entity not within the same common control group, the amortization period shall not exceed the lease term associated with the lessor's lease with the other entity.
- b. Accounted for as a transfer between entities under common control through an adjustment to equity (net assets for a not-for-profit entity) when the lessee no longer controls the use of the underlying asset.

An entity with leasehold improvements accounted for in accordance with the above shall apply the impairment requirements in FASB ASC 360-10-40-4.

Practice Note: BC 22 of the Exposure Draft noted that diversity in practice may exist for accounting for leasehold improvements associated with common control leases. The

FASB indicated that multiple methods of accounting in these situations exist. These methods include, but are not limited to:

1. Amortizing leasehold improvements in full over the shorter of the lease term and useful life of the leasehold improvements
2. 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
3. Accounting for the improvements as a lease payment

When the economic life of leasehold improvements associated with a common control arrangement exceeds the related lease term, a lessee shall disclose the following information:

- a. The unamortized balance of the leasehold improvements at the balance sheet date
- b. The remaining economic life of the leasehold improvements
- c. The remaining lease term

Entities that have not yet adopted FASB ASC 842 on or before the effective date of a final ASU would follow the transition requirements of FASB ASC 842 for the amendments in this Exposure Draft using the same transition method elected to apply FASB ASC 842. However, an entity electing the retrospective transition method to the beginning of the period of adoption (commonly referred to as the “effective date method”) in applying FASB ASC 842 may elect to apply the amendments in this Exposure Draft using either of the prospective approaches described below to avoid retrospectively accounting for leasehold improvements.

For entities that have adopted FASB ASC 842 before the effective date of a final ASU, an entity would be allowed to apply the amendments in this Exposure Draft using one of the following methods:

1. Prospectively to all new leasehold improvements recognized on or after the date that the entity first applies the proposed amendments
2. Prospectively to all new and existing leasehold improvements recognized on or after the date that the entity first applies the proposed amendments, with any remaining unamortized balance of existing leasehold improvements amortized over their remaining economic life determined at that date

3. Retrospectively to the beginning of the period in which the entity applied FASB ASC 842 for leasehold improvements that exist at 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 the opening balance of retained earnings at the beginning of the fiscal year of adoption

Practice Note: The term “leasehold improvements” is not defined by the FASB ASC. BC 21 of the Exposure Draft notes that leasehold improvements, “generally constitute improvements made by a lessee to the underlying asset (the leased asset) for which the lessee is determined to be the owner.” Non-authoritative guidance has widely been utilized for determinations about when the lessee is the owner of the leasehold improvement. We see inconsistent use of the term “leasehold improvements” in practice and these proposed changes could put additional attention on how an entity defines “leasehold improvements” given potential differences in accounting under the Exposure Draft if the improvements are lessee owned or lessor owned.

CPEA Observations

Interaction of Written Terms and Conditions Practical Expedient with the Rest of FASB ASC 842

The written terms and conditions practical expedient is intended to address concerns about the difficulty in determining legally enforceable terms and conditions in common control arrangements. (BC 10). It seems that the FASB intended for written terms and conditions to replace legally enforceability determinations for items that typically would be expected to be written in a lease including lease terms, renewals, and lease payments.

BC 20 of the Exposure Draft notes that the FASB acknowledged that applying the practical expedient does not eliminate the need for an entity to apply other relevant guidance in FASB ASC 842. For example, an entity still would be required to determine whether an arrangement contains lease and nonlease components. While specifying that entities still are required to determine whether an arrangement contains lease and nonlease components, the Exposure Draft does not indicate if an entity should separate those arrangements based on standalone selling prices (FASB ASC 842-10-15-33) or based on written prices specified in a related party lease under common control. It would appear that this would be an area where judgment could be applied and reasonable judgments could be made on similar application questions.

Required Adjustment to Equity

The Exposure Draft requires prescriptive accounting when a common control lessee ceases to control the use of the leasehold improvement. In these situations, the remaining book value is “[a]ccounted for as a transfer between entities under common

control through an adjustment to equity (net assets for a not-for-profit entity)...” It is atypical in the FASB ASC to see recognition and measurement prescribed in the FASB ASC for transfers between entities under common control (for example, see guidance regarding related party loans extinguishment in FASB ASC 470-50-40-2). In this situation, an entry under the FASB ASC to adjust equity, presumably as a dividend, brings potential unintended consequences including potentially prohibited non-pro-rata distributions for a S-corporation lessor or potential violations of state law for dividends when a lessee entity has negative equity. Our understanding is that this requirement for “an adjustment to equity” only applies to non-reciprocal transactions. In a situation in which a related party lessor pays for the leasehold improvement, the “adjustment to equity” would not be required.

Leasehold Improvement Amortization Period Disclosures

As noted above, when the economic life of leasehold improvements associated with a common control arrangement exceeds the related lease term, a lessee is required to disclose, the unamortized balance of the leasehold improvements, the remaining economic life of the leasehold improvements, and the remaining lease term. Our experience is that even small private companies can have numerous material leasehold improvements which could have differing remaining economic lives as well as could be associated with different leases (and, therefore, different lease terms). We read this to require scheduling out remaining economic life and remaining lease term for each material leasehold improvement, which could be voluminous for even small private companies.

Timing of Issuance Predicament

It has been over six and a half years since the issuance of ASU 2016-02. This Exposure Draft comes very late in the implementation process and may drive questions that need to be addressed in redeliberations. Those redeliberations will start no earlier than the expiration of the comment letter period on January 16, 2023, more likely these redeliberations will commence in February 2023 after comment letters are digested and summarized. Therefore, a final ASU cannot be reasonably expected before March 2023.

It should be noted, however, that three FASB Board members dissented to the issuance of the Exposure Draft. The dissenters support the written terms and conditions practical expedient but cite concerns about the decisions related to leasehold improvement amortization periods indicating that they feel it will lead to “misleading financial reporting” and “could incentivize month-to-month common control lease arrangements.” These concerns, as well as unresolved questions regarding the written terms and conditions practical expedient risk jeopardizing an expedited final ASU with private company constituents potentially left in a predicament regarding how to proceed with related party

leases under common control. The dissenters acknowledge this predicament noting they feel that addressing the leasehold improvement issue is, “unnecessary, particularly at this late stage of implementation, and including public entities within the scope of [the leasehold improvement amortization period issue] risks delaying a timely response for those entities truly in need of swift action on the [written terms and conditions practical expedient].”

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