

## Center for Plain English Accounting

AICPA's National A&A Resource Center

### **Related Party Leases** **Overview of Interpretations under FASB ASC 842**

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FASB *Accounting Standards Codification (FASB ASC) 842, Leases*, made substantive changes to the accounting for related party leases in separate financial statements of related parties. FASB ASC 842-10-55-12 indicates:

Leases between related parties should be classified in accordance with the lease classification criteria applicable to all other leases on the basis of the legally enforceable terms and conditions of the lease. In the separate financial statements of the related parties, the classification and accounting for the leases should be the same as for leases between unrelated parties.

The Basis for Conclusions (BC) for Accounting Standards Update (ASU) 2016-02, *Leases (Topic 842) Section A—Leases: Amendments to the FASB Accounting Standards Codification*, paragraph 374 indicates that the FASB, “decided that the recognition and measurement requirements for all leases should be applied by lessees and lessors that are related parties on the basis of legally enforceable terms and conditions of the arrangement, acknowledging that some related party transactions are not documented and/or the terms and conditions are not at arm’s length.”

BC 374 also noted that under FASB ASC 840, *Leases*, specifically FASB ASC 840-10-25-26, entities were required to account for leases with related parties on the basis of the economic substance of the arrangement, which may be difficult when there are no legally enforceable terms and conditions of the arrangement.

While 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. For example, at the 2021 AICPA Engage Conference, the top voted question of an A&A technical panel was:



If we have a month-to-month lease with a related party that we know will go on for a long time, how do we account for that under ASC 842? Do we estimate the economic substance of the agreement, or do we stick to the legally enforceable terms of the lease agreement?

Related party leases application issues in FASB ASC 842 also have been discussed at the [September 2020 FASB Lease Roundtable](#) and [September 11, 2019 Private Company Council Meeting](#). To date, the FASB has not provided any additional authoritative guidance on these types of questions. Given that all private companies will need to adopt FASB ASC 842 for fiscal years beginning after December 15, 2021, private companies will need to make decisions regarding related party leases with the guidance that currently exists. In this report, we provide a review of the interpretations and our perspectives regarding the related party leasing guidance in FASB ASC 842.

At the outset, we think it is important to establish that FASB ASC 842 and BC 374 of ASU 2016-02 are clear that related party leases should be accounted for based on legally enforceable terms and conditions. This could include implied or unwritten legally enforceable terms and conditions. Below, we discuss views and perspectives on the extent to which implied or unwritten legally enforceable terms and conditions may be relevant. FASB felt that identification of legally enforceable terms and conditions would be a simplification over attempting to determine the economic substance in related party leases, especially in cases where no legally enforceable terms and conditions exist. However, while determinations of economic substance in related party leases are no longer required, identification of implied or unwritten legally enforceable terms and conditions may be required. In essence regarding related party leases, one form of complexity (economic substance) has been exchanged for another form of complexity (implied or unwritten legally enforceable terms and conditions).

### Treatment of Oral or Expired Related Party Leases

We previously [provided](#) guidance on how to apply FASB ASC 842 to related party leases in separate financial statements of related parties when the leases are oral or expired. In these situations, we feel the first step is to determine whether the lease contract creates enforceable rights and obligations. If enforceable rights and obligations exist, the entity should determine whether the contract contains an enforceable lease term and termination options. Finally, the entity should determine the lease term under FASB ASC 842. Legal counsel may be necessary to make such determinations.

**Practice Note:** Keep in mind that a lease contract is no longer enforceable when both the lessee and the lessor each have the right to terminate the lease without permission

from the other party with no more than an insignificant penalty. In such arrangements, neither party has enforceable rights or obligations.

### **Illustration: Related Party Lease**



#### **Facts:**

Lessee leases equipment from a related party Lessor. It is an oral, month-to-month arrangement and has been in existence for some years and is expected to continue for many additional years.

#### **Analysis/Conclusion:**

The first question to ask is whether the contract creates enforceable rights and obligations and meets the definition of a lease. Consideration of the laws in the relevant jurisdiction and legal counsel may be necessary. If the arrangement allows both Lessee and Lessor to terminate the lease without permission from the other party with no more than an insignificant penalty, the arrangement is not enforceable.

If Lessee concludes that the arrangement lacks enforceable rights and obligations, then the arrangement does not fall within the scope of FASB ASC 842. If Lessee determines that the arrangement creates enforceable rights and obligations and does meet the definition of a lease contract, Lessee should identify renewal and termination options in the contract exercisable by both Lessee and Lessor. In this illustration, an option to renew the lease each month exists and may be exercisable by either or both parties, depending on the nature of the contract. The contract may contain termination options exercisable by either Lessee or Lessor. However, as indicated above, if the arrangement allows both Lessee and Lessor to terminate the lease without permission from the other party with no more than an insignificant penalty, the arrangement is not enforceable.

Next, the lease term must be determined.

Lessee will need to use judgment in determining how many renewal options, if any, are reasonably certain to be exercised (or termination options not exercised). Intent, estimates, and past practices would be considered. In this illustration, Lessee likely would conclude that its intent is to continue renewing the lease, and past practice reinforces that conclusion. But for how long? How many renewal options are reasonably certain to be exercised, will need to be estimated.

Importantly, intent and past practices are not enough to determine whether exercise of the options are reasonably certain. Economic incentives must exist as well. Lessee would consider the contract-, asset-, entity-, and market-based factors to determine whether the options are reasonably certain of being exercised.

## Treatment of Written Related Party Leases

If a written related party lease exists, questions have arisen about the extent to which entities must go beyond the written related party lease to identify implied (unwritten) enforceable terms. We note three views on this question. These views are detailed below:

**View A:** Consider all legally enforceable explicit and implicit terms.

This view is based on plain language of FASB ASC 842-10-55-12. Deloitte's Roadmap to Applying the New Lease Standard [noted](#) (pg. 322) that,

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).

While it is clear that the FASB wanted to minimize the cost and complexity of the accounting for leases between parties under common control by limiting the application of the guidance in ASC 842 to rights and obligations that are enforceable (i.e., the parties would not impute any terms or otherwise be required to deviate from the enforceable terms to reflect the substance of the arrangement), we do not think that it would be appropriate to ignore any facts and circumstances related to rights and obligations outside of a lease contract. That is, terms and conditions not written in an agreement or that are included in contracts separate and apart from the lease contract may create enforceable rights and obligations for the parties subject to the lease. For example, while the term of an arrangement may be explicitly limited to six months, factors outside the contract may indicate that the term is longer.

The determination of whether terms and conditions not written in a lease agreement create enforceable rights and obligations to the parties subject to the lease involves judgment and, in some cases, may involve legal questions that should be evaluated with the assistance of legal counsel.

**View B:** Consider implied legally enforceable terms if the written contract (explicit terms) (1) does not align with other transactions/agreements (e.g., leasehold improvements), or (2) is "uneconomic."

This view is based on FASB's intent to simplify accounting in this area (BC 374) while acknowledging plain language of FASB ASC 842-10-55-12. KPMG, PWC, and Grant

Thornton have expressed views that are consistent with View B. Specifically, [KMPG's Leases Handbook](#) noted (pg. 409) that,

While an entity should generally consider that the enforceable rights and obligations of the parties may extend beyond those written into the contract, in the case of a lease between parties under common control, we believe it was the Board's intent to significantly simplify the accounting for such leases by following easily identifiable terms and conditions. Identifying enforceable rights and obligations not included in a written contract may be extremely difficult in a lease between parties under common control because of the related party nature of the arrangement.

Therefore, while we acknowledge that looking only to the written terms of a lease between two parties under common control is inconsistent with looking to the enforceable rights and obligations of the entities more broadly in other scenarios, we believe this is consistent with the intent of the Board when establishing the related party leasing requirements in Topic 842. (footnote references omitted)

That said, if the written contract (including if there is no written contract) does not align with other related transactions or agreements – e.g. a one month written lease term but the lessee is constructing significant leasehold improvements with an economic life much longer than the written lease term – it should be considered whether there is an unwritten contract or understanding. Involvement of qualified legal counsel may be necessary to determine if an unwritten contract or understanding creates enforceable rights and obligations on the parties.

[PWC's Leases](#) guide has a similar interpretation indicating (pg. 3-5):

The lessee and lessor should look only to legally enforceable rights when classifying the lease. In identifying the legally enforceable rights, it would be reasonable to start with a review of the written contract. However, due to the relationship between the two parties, the legal lease provisions in the written contract may be uneconomic or a detailed contract may not exist at all. If this is the case, it would be helpful to involve legal counsel to understand if there are legal rights that exist outside of a written contract. For example, within office space leased from a related party under a nonrenewable, one-year managed service arrangement, a lessee may install leasehold improvements with an economic life of five years. This may indicate that the lessee expects to use the space longer than the one-year lease term and therefore the written contract terms of the arrangement may be considered uneconomic. Furthermore, that may be a reasonable expectation given that management of the lessee and lessor often include the same decision makers. Therefore, in this case it could be helpful to involve legal counsel.

[Grant Thornton's Leases Navigating the Guidance in ASC 842](#) provides guidance that is consistent with View B indicating (pgs. 138-139):

To identify the legally enforceable terms and conditions in related-party leases, an entity should first look to the written lease agreement, provided that a written agreement exists. If a related-party lease is documented in the same manner as leases containing similar assets with unrelated parties, and if the terms and conditions of the agreement are legally enforceable, then the entity should analyze the lease similarly to its unrelated-party leases. However, if the facts and circumstances surrounding a related party lease differ from leases involving similar assets with unrelated parties (such as the installation of long-term fixed assets in a space leased for less than one year) or if there is limited or no written documentation of the terms and conditions, then the entity should endeavor to understand the enforceable rights and obligations regarding the use of the underlying asset, taking into consideration the customary business practices between the parties. An entity may need to obtain input from legal counsel to understand the enforceability of any terms, conditions, and mutual understanding, whether or not they are documented. Once the legally enforceable terms and conditions are identified, the entity should base its lease assessment on those terms and conditions.

**View C: Consider only explicit terms (written contract).**

This view is based on intent to simplify accounting in this area (BC 374) and disclosures are required for related party transactions which could address implied terms.

### **CPEA View**

We think that View A and View B are currently reasonable interpretations of FASB ASC 842-10-55-12 on related party leases. View A is a strict reading of FASB ASC 842-10-55-12. View B is similar to View A but allows for reliance solely on explicit (written) terms if those explicit terms approximate economic terms. View B's shortcut seems to be based on the FASB's widely acknowledged intent to try to simplify related party leases. We also note that legal analysis for implied enforceable terms generally is unnecessary for unrelated party leases. Accordingly, View B would be consistent with accounting for the leases "the same as for leases between unrelated parties" (FASB ASC 842-10-55-12). Furthermore as noted by KPMG, identification of implied enforceable terms with related party leases is challenging and View B could be viewed as using written terms that approximate economic terms as a proxy.

We do not feel that View C is an appropriate application of FASB ASC 842-10-55-12. While FASB has expressed an intent to simplify related party lease accounting, we do not feel the plain language of FASB ASC 842-10-55-12 supports consideration of only explicit

(written) terms. Based on FASB ASC 842 definition of a lease, consideration of both explicit and implicit legally enforceable terms is required. If FASB wished to limit consideration of legally enforceable terms to just explicit (written) terms for related party leases, it could have indicated so but, it has not. Further, the FASB has had six years to make authoritative clarifications to FASB ASC 842-10-55-12 and has chosen not to do so. Left with these facts, we are unable to conclude that View C is an appropriate application of FASB ASC 842-10-55-12.

Finally, in our experience with interpretive matters, we have found that views based on non-authoritative statements and intentions (including the BC) tend to fade as time passes from the issuance of an ASU. Accordingly, it is possible that View B will fade as time passes leaving View A as the sole surviving view.

### CPEA Practical Advice



From a practical perspective, practitioners may wish to advise clients to put in writing related party leases with terms that approximate economic terms. This would appear to minimize the need for legal consultation or minimize the magnitude of legal consultation. Ironically, determination of economic terms for related party leases may seem similar to determination of “economic substance” in FASB ASC 840. It is notable though that the old economic substance concept in FASB ASC 840 could extend beyond explicit and implied legally enforceable terms and conditions. In one sense, the shift to legally enforceable terms and conditions has limited the challenge of what some have called “divining the economic substance” but created another challenge of determining implied legally enforceable terms in cases where leases are uneconomic.

Practitioners should closely monitor this area for further developments. CPEA will keep members abreast of any further interpretations and standards setting in this area.

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