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New-and-improved accounting rules for common control leases

On March 27, 2023, the Financial Accounting Standards Board (FASB) published narrowly drawn amendments to the lease accounting rules. The updated guidance clarifies issues that are relevant to rental agreements between businesses that have the same owner.

Written vs. verbal leases

Accounting Standards Update (ASU) No. 2023-01, *Leases (Topic 842) Common Control Arrangements,* explains how related business entities that are controlled by the same owner determine whether a lease exists. Specifically, it provides an optional practical expedient to *private* companies and not-for-profit organizations that aren't conduit bond obligors. (A practical expedient is an accounting workaround that allows a company to use a simpler route to get to the same outcome.) The guidance settles questions about how to approach verbal common control leases and whether legal counsel is required to determine the terms and conditions of a lease.

The practical expedient is applicable only for *written* leases. Under the updated guidance, a private company electing the practical expedient must use the written terms and conditions of a common control arrangement to determine whether a lease exists and, if so, how to account for it. In the case of a lease agreement that's verbal — as is often the case between private entities under common control — the company must document the existing unwritten terms before applying the lease accounting rules.

The lessee isn't required to determine whether written terms and conditions are enforceable when applying the practical expedient. In addition, companies are allowed to apply the practical expedient on an arrangement-by-arrangement basis.

Leasehold improvements

The accounting rules related to certain leasehold improvements have also changed for *both* public and private organizations under ASU 2023-01. Examples of leasehold improvements include installing carpet, painting and building out the space for the lessee's needs. For example, a salon might install sinks and plumbing fixtures, a chemical manufacturer might need ventilation for its production process and an eco-friendly restaurant might design a rooftop garden to attract patrons.

The amendments require lessees to amortize leasehold improvements over the improvements' useful lives to the common control group — regardless of the lease term. When the lessee no longer controls that underlying asset, the transfer of those improvements must be accounted for through equity or net asset. The improvements remain subject to the impairment requirements of Accounting Standards Codification (ASC) Topic 360, *Property, Plant and Equipment*.

Implementation guidance

ASU No. 2023-01 is an amendment to ASC Topic 842, *Leases*, which was issued in 2016. This standard requires the full effect of entities' long-term lease obligations to be reported on the balance sheet. It went into effect for public entities in 2019 and for private entities in 2022.

The new-and-improved rules will be effective for fiscal years beginning after December 15, 2023, including interim periods within those fiscal years. Early adoption is permitted for both interim and annual financial statements that haven't yet been made available for issuance. If a company adopts the amendments in an interim period, the company must adopt them as of the beginning of the fiscal year that includes that interim period.

If your company decides to adopt ASU 2023-01 concurrently with the adoption of Topic 842, you should use the same transition approach as that standard. If your company adopts the rules in a subsequent period, you can do so either retrospectively or prospectively.

For more information

Does your company rent property from a related party? We can help you report these arrangements in accordance with the updated guidance. Our accounting pros understand how to determine whether a common control lease exists and how to report leasehold improvements and other fixes that have been made to rented property. Contact us for more information.