ACCOUNTING BRIEF

Lessee accounting for tenant improvement allowances

September 2024

SUMMARY

In many leases, lessors provide lessees with lease incentives. Topic 842, Leases, of the Financial Accounting Standards Board (FASB) Accounting Standards Codification (ASC) does not provide guidance on accounting for contingent lease incentives. This publication provides guidance on accounting for these arrangements.

1. BACKGROUND

In many leases, lessors provide lessees with lease incentives. Often, those incentives are paid or payable at the commencement date of the lease. However, certain other leases contain incentives that are contingent upon future events or future actions taken by the lessee. For example, the lessor may offer to reimburse the lessee for a specified portion of the cost of leasehold improvements, with reimbursement to occur when the lessee provides evidence of the costs incurred. Because ASC 842 does not provide guidance on accounting for contingent lease incentives, questions have arisen as to how to account for them.

Paragraph 842-10-55-30 describes lease incentives as follows:

> Lease incentives include both of the following:
>
> a. Payments made to or on behalf of the lessee
>
> b. Losses incurred by the lessor as a result of assuming a lessee's preexisting lease with a third party. In that circumstance, the lessor and the lessee should independently estimate any loss attributable to that assumption. For example, the lessee's estimate of the lease incentive could be based on a comparison of the new lease with the market rental rate available for similar underlying assets or the market rental rate from the same lessor without the lease assumption. The lessor should estimate any loss on the basis of the total remaining costs reduced by the expected benefits from the sublease for use of the assumed underlying asset

Generally, if the lessor makes a payment to, or on behalf of, the lessee, that would represent a lease incentive. A common example of such a lease incentive is a tenant improvement allowance. These allowances provide the lessee with funds or credits to modify the leased asset (generally, leased space). The lessee either makes the modifications itself or hires another party (which may even be the lessor) to perform the work. The lessor may either pay the allowance at lease commencement, treat it as a reduction in lease payments or reimburse the lessee when the improvements are made.

Other improvements, however, are considered property of the lessor. If the lessor makes a payment and receives a distinct good or service in exchange (such as a lessor-owned leasehold improvement), that payment would not be considered an incentive. Instead, it would represent the acquisition of a tangible asset by the lessor. Therefore, it is essential to determine the owner of the improvements.

2. DETERMINING THE OWNER OF LEASEHOLD IMPROVEMENTS

ASC 842 does not provide explicit guidance on how to determine the owner of a leasehold improvement, which is an important consideration when determining whether the payments for such improvements constitute a lease incentive.

Factors to consider in determining the accounting owner of the improvements include, but are not limited to:

- Is the lessee or the lessor the legal owner of the improvements upon completion?

  - While this is a factor to consider, it is rarely determinative on its own.
- Is the lessee required by the lease agreement (or another agreement) to construct or install specific leasehold improvements?
  - If the lessee is required to do so, it would suggest that the lessee is not the owner during construction or installation.
  - If the lessee is not required to do so, it would suggest that the lessee is acting at its own discretion and is the owner of the improvements.
- Is the lessee allowed to remove or alter the improvements without obtaining the lessor's approval or compensating the lessor?
  - If the lessee has this ability, that suggests that the lessee is the owner of the improvements.
  - If the lessee cannot remove or alter the improvements without the approval of the lessor, or without compensating the lessor, that suggests that the lessor is the owner of the improvements.
- Are the improvements of such a specialized nature that the lessor (or a subsequent lessee) would not be likely to benefit from the improvements upon the end of the lease?
  - If so, that suggests that the lessee is the owner of the improvements.

3. ACCOUNTING FOR TENANT IMPROVEMENT ALLOWANCES

A tenant improvement allowance paid or payable at or before lease commencement results in a reduction in the right-of-use asset that the lessee records.

A number of lease incentives are structured such that nothing is payable at commencement; instead, the lessor's payments become payable upon the resolution of some condition (e.g., once costs of construction on the improvements have been incurred). The payments represent reimbursement of qualifying expenditures, up to a certain amount or percentage. Until the costs are incurred, no amounts are owed by the lessor to the lessee.

ASC 842 does not directly address the accounting for such incentives. As such, we believe there are multiple approaches that would be considered acceptable and would represent an accounting policy election.

One such approach would be for the lessee to estimate at commencement any lease incentive amounts to be received when the amounts are reasonably certain to be incurred (that is, they are within the control of the lessee). This would have the effect of reducing lease payments, thereby reducing the lease liability balance and the balance of the right-of-use asset at commencement.

Another approach would be for the lessee to account for any lease incentives that are received or become receivable after commencement, and were not recognized at commencement, as a reduction in lease payments that reduce the balances of its lease liability and its right-of-use asset akin to a lease remeasurement.

A third alternative would be that upon incurring qualifying expenditures, the lessee should reduce its right-of-use asset and lease liability and recognize a cumulative catch-up adjustment to lease expense so that, prospectively, periodic lease expense is recognized as if the lease incentive was receivable as of the commencement date.

4. AMORTIZATION OF LEASEHOLD IMPROVEMENTS

In accordance with ASC 842-20-35-12, a lessee generally amortizes its leasehold improvements over the shorter of the useful life of the improvements or the remaining lease term. However, the amortization period for leasehold improvements should be their useful life when ownership of the underlying asset transfers to the lessee, the lessee is reasonably certain to exercise an option to purchase the underlying asset or the useful life of the leasehold improvements is shorter than the remaining lease term. Otherwise, the amortization period for those improvements is the remaining lease term.

4.1 Amortization of leasehold improvements in common control

In accordance with ASC 842-20-35-12A, leasehold improvements associated with a lease between entities under common control should be:

a. Amortized over the useful life of those improvements to the common control group as long as the lessee controls the use of the underlying asset through a lease. If the lessor obtained the right to control the use of the underlying asset through a lease with another entity not within the same common control group, the amortization period shall not exceed the amortization period of the common control group determined in accordance with ASC 842-20-35-12.

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.

In that same paragraph, the FASB also clarified that leasehold improvements associated with common control leases should not be considered lease payments and should be assessed for impairment in accordance with the relevant guidance in ASC 360, *Property, Plant, and Equipment*, for long-lived assets to be disposed of other than by sale, considering the useful life to the common control group.

4.2 Leasehold improvements acquired in a business combination

In addition to the accounting for improvement allowances addressed above, the acquiree’s leasehold improvements should be recognized by the acquirer on the acquisition date and measured at their fair value. The amortization period for leasehold improvements acquired in a business combination should be their remaining useful life when ownership of the underlying asset transfers to the lessee, the lessee is reasonably certain to exercise a purchase option for the underlying asset or the remaining useful life of the leasehold improvements is shorter than the remaining lease term as of the acquisition date. Otherwise, when the leasehold improvements’ useful life is longer than the remaining lease term as of the acquisition date, the amortization period for those leasehold improvements should be the remaining lease term.

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