Applying VIE Guidance to Common Control Leasing Arrangements

HIGHLIGHTS OF THE UPDATE

On March 20, 2014, the Financial Accounting Standards Board (FASB) issued Accounting Standards Update (ASU) 2014-07, Consolidation (Topic 810): Applying Variable Interest Entities Guidance to Common Control Leasing Arrangements, providing private companies with accounting alternatives for lease arrangements meeting specified criteria. This ASU is the third accounting alternative for private companies endorsed by the FASB based upon recommendations of the Private Company Council (PCC).

Who is Affected by the Amendment in the Alternative?

This alternative is available to private companies, which are defined as entities other than public business entities, not-for-profit entities, or employee benefit plans within the scope of Topics 960 through 965 on plan accounting.

In December 2013, the FASB issued ASU 2013-12, Definition of a Public Business Entity – An addition to the Master Glossary, which defines a public business entity for purposes of generally accepted accounting principles (GAAP) in ASUs issued subsequent to ASU 2013-12 (it does not change existing definitions of public and nonpublic entities contained within GAAP resulting from standards prior to ASU 2013-12). This definition is not limited to companies that are registered with the U.S. Securities and Exchange Commission, but includes, among others, entities whose financial statements are included in filings with the SEC and entities with securities traded in the OTC markets. As such, an entity considering adoption of the accounting alternatives provided in this Update should first evaluate whether they are within the scope of the Update. See DHG A&A Update FASB Issues Definition of Public Business Entity for additional information.

Main Provisions

Current GAAP requires a reporting entity to consolidate a Variable Interest Entity (VIE) when that reporting entity is considered to be the primary beneficiary of the VIE. As a result, VIE guidance requires in certain circumstances, a reporting entity (lessee) to consolidate a lessor entity when both entities are under common control.

This alternative was issued in response to feedback from private company stakeholders indicating that the benefits of applying VIE guidance do not justify the related costs. Private company stakeholders state,
generally, that the primary purpose of establishing a separate lessor entity is for tax, estate-planning, and legal-liability purposes—not to structure off-balance-sheet financing arrangements for financial reporting purposes. In instances in which a lessor entity is consolidated by the private company lessee on the basis of VIE guidance, most users of the private company lessee entity’s financial statements stated that consolidation is not relevant to them because they focus on the cash flows and tangible worth of the standalone private company lessee entity, as opposed to the consolidated cash flows and tangible worth of the reporting entity as presented under GAAP. Those users also stated that consolidation of the lessor entity distorts the financial statements of the lessee entity. Consequently, users who receive consolidated financial statements often request a consolidating schedule to enable them to reverse the effects of consolidating the lessor entity.

The PCC decided that the concerns expressed about the cost and complexity of applying VIE guidance and the lack of relevance to users when consolidating lessor entities under common control indicated that a change to VIE guidance was warranted. In issuing the ASU, the FASB endorsed the recommendations of the PCC.

Under the alternative, provided that certain criteria are met, a private company lessee would not need to perform an evaluation as to whether its relationship would require the consolidation of the lessor entity under VIE guidance. In order to qualify for the alternative the following criteria must be met:

a. The private company lessee (the reporting entity) and the lessor entity are under common control
b. The private company lessee has a lease arrangement with the lessor entity
c. Substantially all activities between the private company lessee and the lessor are related to leasing activities (including supporting leasing activities) between those two entities
d. If the private company lessee explicitly guarantees or provides collateral for any obligation of the lessor entity related to the asset being leased by the private company, then the principal amount of the obligation at inception of such guarantee or collateral arrangement does not exceed the value of the asset leased by the private company from the lessor entity

In applying this alternative, a private company would provide disclosures about the lessor entity as follows:

- The amount and key terms of liabilities recognized by the lessor entity that expose the private company lessee to having to provide financial support to the lessor entity
- A qualitative description of circumstances (for example commitments and contingencies) not recognized by the lessor entity that expose the private company lessee to having to provide financial support to the lessor entity
- Disclosures currently required by GAAP such as guarantees, leases and related party transactions (same note or cross-reference between notes)

The following are some implementation considerations:

- If adopted, it is an accounting policy election applicable to all leasing arrangements that meet the criteria
- Adoption is effected using a full retrospective approach. As such, for all prior periods presented, the lessor entity would no longer be consolidated under VIE guidance
- The ASU is effective for the first annual period beginning after December 15, 2014, and interim periods within annual periods beginning after December 15, 2015. Early application is permitted,
including application to any period for which the private company’s annual or interim financial statements have not yet been made available for issuance

**Final Thoughts**
The ASU does not change GAAP applicable to VIEs for those reporting entities not meeting the “private company” definition, or those not adopting the alternative, which will continue to apply the existing guidance. Also, relationships with lessor entities within the scope of the alternative still need to be evaluated for consolidation under other applicable accounting guidance such as ASC Subtopic 810-20 related to control of partnerships and similar entities.

Judgment will need to be applied in determining which lessor entity arrangements qualify under the alternative. For example, GAAP does not define entities under common control, so relationships in which control does not rest in the same owner (such as when the owners are extended family members or related parties), will require additional analysis. Further, if the activities of the lessor are broader, such as when the lessor has properties leased to other parties in addition to the private company, more analysis may be required than in those situations where the lessor entity’s property is leased in its entirety to the reporting entity.

As with adopting any change in accounting principle, various factors should be considered prior to electing the alternative (see the “Adoption” section of Appendix A, Frequently Asked Questions).
APPENDIX A – FREQUENTLY ASKED QUESTIONS

Criteria

1. **What is meant by the term “common control”?**

   Criterion (a) of paragraph 810-10-15-17A requires the private company lessee and the lessor entity to be under *common control*. The term common control is not clearly defined within GAAP. Rather than define common control (which would take significant additional analysis, delaying the issuance of the ASU) the PCC and the FASB provided some guidance in the basis for conclusions of the ASU as to how to assess whether or not entities are under common control.

   Public companies generally look to SEC observations documented in EITF Issue 02-5, *Definition of “Common Control” in Relation to FASB Statement No. 141* (a final consensus was never reached), and other SEC guidance for determining entities that are under common control when applying current GAAP. The Board and the PCC concluded common control is broader than the notion provided by the SEC observations on EITF Issue 02-5. For example, in the basis for conclusions it was stated that an entity owned by a grandparent and another entity owned by a grandchild could, depending on the facts and circumstances, be considered as entities under common control for the purposes of applying this accounting alternative.

   We believe it is likely that in many instances, such as 100% ownership of the reporting entity and the lessor entity(ies) by the same individual or entity, it will be clear that criteria (a) in paragraph 810-10-15-17A is met, but there will be instances where further evaluation of facts and circumstances will be necessary.

2. **Substantially all activities between the lessee and the lessor must be related to leasing activities (including supporting leasing activities) between those two entities. What are examples of activities which would be within the scope?**

   The following are examples of leasing activities (including supporting leasing activities) between the private company lessee and the lessor legal entity from the ASU:

   a. A guarantee or collateral provided by the private company lessee to the lender of the lessor for indebtedness secured by the asset(s) leased by the private company lessee.

   b. A joint and several liability arrangement for indebtedness of the lessor, for which the private company lessee is one of the obligors, that is secured by the asset(s) leased by the private company lessee.

   c. Paying property taxes, negotiating the financing, and maintaining the asset(s) leased by the private company lessee.

   d. Paying income taxes of the lessor when the only asset owned by the lessor is being leased either by only the private company or by both the private company lessee and an unrelated party.

   The following are examples of activities not considered to be leasing activities:

   a. Paying income taxes of the lessor on income generated by an asset which is not leased by the private company lessee.
b. A purchase commitment (other than for the acquisition of or the support of the leased asset).

Adoption

1. What factors should an entity consider in deciding whether or not to adopt the accounting alternative?

As with any of the alternatives for private companies, factors entities should consider before adopting include:

- Determine the entity is within the scope of the type of entity eligible for applying the alternative.
- Determine that the requisite criteria are met.
- Ensure those charged with governance are adequately informed and have sufficient opportunity to evaluate the adoption of the alternative.
- Consider informing primary financial statement users of the alternative and determining whether the users will object to adoption.
- Review loan covenants to determine if there will be an impact on the covenants, whether lender approval of changes in accounting is required and similar matters.
- Potential future user needs, particularly if a major change in creditors or ownership is being contemplated, or if the entity is considering a future public offering.

2. Is the alternative expected to be made available to public business entities, not-for-profit entities and employee benefit plans in the future?

The FASB concluded that the accounting alternative should not be extended to public business entities and employee benefit plans because the arrangements this accounting alternative addresses are more prevalent in the context of private companies. Not-for-profit entities already are substantially excluded from the scope of VIE guidance.

3. If the relationships and arrangements do not enable the adoption of the alternative, does this mean there is a presumption the entities will need to be consolidated?

No, failure to meet the criteria a-d in ASC 810-10-15-17A does not necessarily mean that a lessee entity will need to consolidate the lessor entity. In the event the criteria are not met, the arrangements will continue to be evaluated within the existing VIE and voting interest guidance.

4. At the time of adoption, what are other items that need to be considered?

In the event the entity qualifies for the adoption of the alternative, no further evaluation would have to be made under VIE guidance. Financial statements would be retrospectively adjusted to apply the alternative as of the beginning of the earliest year presented (or to the beginning balances in single year presentations). Matters to consider are the following:

- If the lessee has a financial interest in the lessor, it would need to determine the basis for carrying that investment (cost or equity method). Although it probably would be infrequent, there could be situations whereby consolidation would be required under the voting interest model of Topic 810 (e.g. Subtopic 810-20 on control of partnerships and similar entities).
• With respect to the leases, accounting consideration will need to include assessment as to whether such leases are operating or capital.

When retrospectively applying the alternative, lease accounting and investment accounting will need to be applied to all periods presented. For example, capital leases or cost method investments in the lessor will need to be properly recorded as such in all periods presented. Furthermore, any difference between the net amount removed from the balance sheet of the lessee and the amount of retained interest in the VIE should be recognized as a cumulative effect adjustment to beginning retained earnings. This amount should be disclosed separately from the effects on net assets/liabilities from deconsolidating a previously consolidated lessor entity.

5. **What are the implications if an entity adopts after the effective date of the first annual accounting period beginning after December 15, 2014?**

If the reporting entity had leasing arrangements meeting the criteria in the ASU at the effective date of the ASU, adoption after the effective date would be subject to the change in accounting principle guidance under ASC 250, *Accounting Changes and Error Corrections*, including the requirement that the entity justify the change on the basis that it is preferable.

6. **Can an entity choose to apply the guidance to certain qualifying lease arrangements but not to others?**

   No. The accounting alternative, when elected, is an accounting policy election that should be applied by a private company to all current and future lessor entities under common control that meet the criteria for applying this approach.

7. **Does the above requirement to apply the guidance to all common control leasing arrangements preclude an entity from issuing combined financial statements?**

   No. The accounting guidance provides an alternative within Topic 810, *Consolidation*, which provides guidance for consolidation under the voting interests model and the VIE model. While there is only limited guidance within GAAP pertaining to combined financial statements, 810-10-55-1B states in part:

   "There are circumstances, however, in which combined financial statements (as distinguished from consolidated statements) of commonly controlled entities are likely to be more meaningful (emphasis added) than their separate statements. For example, combined financial statements would be useful if one individual owns a controlling interest in several entities that are related in their operations."

   Accordingly, we believe there may be situations whereby the combination of a lessee entity and a particular lessor entity may provide "more meaningful" information. In such a situation, the financial statement disclosures should be clear that the lessee entity has adopted the accounting alternative. Disclosures should also be clear that the basis of presentation is combined (versus consolidated) financial statements, the nature of the relationships and why combined financials are being presented. Care should be exercised to combine the equity interests and not refer to controlling/ non-controlling interests or any other implications that the entities are being consolidated under Topic 810.
Documentation

1. **What documentation is required for lessor entities which are no longer consolidated under the alternative to demonstrate consolidation is not required?**

   Private company lessees should document how they meet the criteria in 815-10-15-17A and accumulate the required information for disclosures.

Presentation and Disclosure

1. **Are disclosures required to state the accounting alternative may not be consistent with VIE accounting for public business entities or for other private companies who choose not to adopt the alternative?**

   No. The PCC alternatives are GAAP. There are no requirements to indicate that the accounting differs from public business entities or that they may differ from financial statements of other private companies who do not adopt the alternative. However, similar to other areas where GAAP allows for selection among acceptable accounting alternatives, accounting policy disclosures will include that the alternative has been adopted. Also, in the year of adoption, the change in accounting principle and its effects on the financial statements should be disclosed in accordance with ASC Topic 250, Accounting Changes and Error Corrections (except for disclosures in 250-10-50-1(b)(2)).

2. **What disclosures are required upon adoption?**

   The accounting change will be addressed in accordance with ASC 250, Accounting Changes and Error Corrections (as modified for the alternative) and will include the following disclosures for financial statements in the period of adoption:

   a) The nature of and reason for the change
   b) The method of applying the change, including:
      i. A description of any prior-period information that has been retrospectively adjusted,
      ii. the cumulative effect of the change on retained earnings (or other components of equity) as of the beginning of the earliest period restated.

   The alternative does not require disclosures of the effects of the adoption on the results of operations financial condition or cash flows normally required for accounting changes pursuant to 250-10-50-1(b)(2).

3. **What ongoing disclosures are required in financial statements?**

   Unless the lessor entity is consolidated through accounting guidance other than VIE guidance, a private company lessee shall disclose the following:

   a. Accounting policy note which discloses the entity utilizes the alternative
   b. The amount and key terms of liabilities (for example, debt, environmental liabilities, and asset retirement obligations) recognized by the lessor entity that expose the private company lessee to providing financial support to the legal entity. For example, a private company lessee exposed to debt of the legal entity should disclose information such as the amount of debt, interest rate, maturity, pledged collateral, and guarantees associated with the debt.
c. A qualitative description of circumstances (for example, certain commitments and contingencies) not recognized in the financial statements of the lessor legal entity that expose the private company lessee to providing financial support to the legal entity.

In applying the disclosure requirements, a private company lessee shall consider exposures through implicit guarantees. The determination as to whether an implicit guarantee exists is based on facts and circumstances. Those facts and circumstances include, but are not limited to, whether:

a. There is an economic incentive for the private company lessee to act as a guarantor or to make funds available
b. Such actions have happened in similar situations in the past
c. The private company lessee acting as a guarantor or making funds available would be considered a conflict of interest or illegal.

In disclosing the above information about the lessor legal entity, a private company lessee should present the disclosures in combination with the disclosures required by other guidance (for example, in Topics 460 on guarantees, 850 on related party disclosures, and 840 on leases). The disclosures could be made by combining all disclosures in a single note or by including cross-references within the notes to the financial statements.

Other

1. What happens if conditions change such that the criteria for applying the accounting alternative cease to be met?

If any of the criteria for applying the alternative subsequently cease to be met, a private company shall apply VIE guidance at the date of change on a prospective basis. Not meeting the criteria to qualify for the accounting alternative does not automatically result in consolidation. Instead, the lessor entity will need to be evaluated under VIE and voting interest guidance to determine if consolidation is required.

2. What if an entity is no longer a private company or its users request the entity no longer apply the alternative?

In the event an entity adopts the alternative and later decides that changes in circumstances warrant a change in accounting, there may be implications. For example, if the entity undertakes an IPO or is acquired and the entity’s financial statements must be filed with the SEC, such financials would need to be prepared under applicable SEC requirements. As such, financial statements of historical periods presented in SEC filings may need to be restated to eliminate the effects of the adoption of the alternative.

3. What conditions could cause an entity to no longer meet criteria a. through d. in 810-10-15-17A?

The following are a few examples that may cause the entity to cease meeting the required criteria:

- If the entities cease to be under common control,
- If the debt is refinanced and the value of the asset(s) being leased is less than the debt, or
- If the lessee enters into other arrangements with the lessor such as purchases of products or guarantees of indebtedness unrelated to the leased asset(s).
APPENDIX B – DEFINITION OF A PUBLIC BUSINESS ENTITY

ASU 2013-12, Definition of a Public Business Entity

See DHG A&A Update FASB Issues Definition of Public Business Entity for additional guidance as to which entities qualify as a public business entity. The following in an excerpt from Accounting Standards Update No. 2013-12 from the FASB:

Public Business Entity
A public business entity is a business entity meeting any one of the criteria below. Neither a not-for-profit entity nor an employee benefit plan is a business entity.

a. It is required by the U.S. Securities and Exchange Commission (SEC) to file or furnish financial statements, or does file or furnish financial statements (including voluntary filers), with the SEC (including other entities whose financial statements or financial information are required to be or are included in a filing).

b. It is required by the Securities Exchange Act of 1934 (the Act), as amended, or rules or regulations promulgated under the Act, to file or furnish financial statements with a regulatory agency other than the SEC.

c. It is required to file or furnish financial statements with a foreign or domestic regulatory agency in preparation for the sale of or for purposes of issuing securities that are not subject to contractual restrictions on transfer.

d. It has issued, or is a conduit bond obligor for, securities that are traded, listed, or quoted on an exchange or an over-the-counter market.

e. It has one or more securities that are not subject to contractual restrictions on transfer, and it is required by law, contract, or regulation to prepare GAAP financial statements (including footnotes) and make them publicly available on a periodic basis (for example, interim or annual periods). An entity must meet both of these conditions to meet this criterion.

An entity may meet the definition of a public business entity solely because its financial statements or financial information is included in another entity’s filing with the SEC. In that case, the entity is only a public business entity for purposes of financial statements that are filed or furnished with the SEC.
APPENDIX C – ILLUSTRATIVE EXAMPLES

The following examples are included in the ASU (see ASC 810-10-55-205) to illustrate the application of the guidance in paragraph 810-10-15-17A on determining whether a reporting entity that is a private company can elect the accounting alternative not to apply VIE guidance to a legal entity under common control:

a. Common control leasing arrangement with no leasing or other activities with unrelated parties (Example A)
b. Common control leasing arrangement with additional leasing activities with unrelated parties (Example B)
c. Common control leasing arrangement with additional activities other than leasing or for the support of leasing (Example C).

Examples A through C share all of the following assumptions:

a. The sole owner of Manufacturing Entity (a private company) is also the sole owner of Lessor Entity.
b. Manufacturing Entity has pledged its assets as collateral for Lessor Entity’s mortgage.
c. The common owner of both entities has provided a guarantee of Lessor Entity’s mortgage as required by the lender.
d. Manufacturing Entity leases its manufacturing facility from Lessor Entity.
e. The value of the manufacturing facility leased by Manufacturing Entity exceeds the principal amount of Lessor Entity’s mortgage at inception of the mortgage.
f. Manufacturing Entity has elected to apply the accounting alternative described in paragraph 810-10-15-17A.

> > > > Example A: Common Control Leasing Arrangement with No Leasing or Other Activities with Unrelated Parties

Lessor Entity owns no assets other than the manufacturing facility being leased to Manufacturing Entity. Manufacturing Entity pays property taxes on behalf of Lessor Entity and maintains the manufacturing facility. Therefore, Manufacturing Entity meets all four criteria in paragraph 810-10-15-17A and, as a result of its elected accounting policy, would apply the accounting alternative to Lessor Entity based on the following:

a. Manufacturing Entity and Lessor Entity are under common control.
b. Manufacturing Entity has a lease arrangement with Lessor Entity.
c. Substantially all the activities between Manufacturing Entity and Lessor Entity are related to the lease of the manufacturing facility to Manufacturing Entity. Providing collateral, paying property taxes, and maintaining the manufacturing facility are considered to be leasing activities between Manufacturing Entity and Lessor Entity as described in paragraph 810-10-55-9.
d. The value of the manufacturing facility leased by Manufacturing Entity exceeds the principal amount of Lessor Entity’s mortgage at inception of the mortgage.
If in two years the value of the manufacturing facility declines below the principal amount of the mortgage, Manufacturing Entity would continue to apply this accounting alternative (assuming no other changes have occurred) because the manufacturing facility met criterion (d) in paragraph 810-10-15-17A at inception of the arrangement.

If Lessor Entity refines or enters into a new obligation that requires collateralization or a guarantee by Manufacturing Entity, then Manufacturing Entity would be required to reassess whether criterion (d) in paragraph 810-10-15-17A is met at the inception of the new obligation. For example, if Lessor Entity refinances the mortgage (collateralized by assets of Manufacturing Entity) and the new principal balance of the mortgage exceeds the value of the manufacturing facility, then the arrangement would no longer meet criterion (d). Not meeting the criteria to qualify for the accounting alternative does not automatically result in consolidation. Instead, Lessor Entity will need to be evaluated under this Topic, including VIE guidance, for consolidation and related disclosure requirements.

>> > Example B: Common Control Leasing Arrangement with Additional Leasing Activities with Unrelated Parties

Manufacturing Entity leases 3 of the 10 floors of the manufacturing facility from Lessor Entity. Lessor Entity leases the remaining seven floors of the same manufacturing facility to unrelated parties. Manufacturing Entity continues to pledge its assets as collateral for the mortgage that financed the purchase of the entire manufacturing facility (that is, all 10 floors). In this Example, Manufacturing Entity meets all four criteria in paragraph 810-15-17A and as a result of its elected accounting policy, would apply the accounting alternative to Lessor Entity based on the following:

a. Manufacturing Entity and Lessor Entity are under common control.
b. Manufacturing Entity has a lease arrangement with Lessor Entity.
c. Substantially all the activities between Manufacturing Entity and Lessor Entity are related to the lease of the manufacturing facility to Manufacturing Entity, even though part of the manufacturing facility is also leased to unrelated parties.
d. The value of the manufacturing facility leased by Manufacturing Entity exceeds the principal amount of Lessor Entity’s mortgage at inception of the mortgage.

Subsequently, Lessor Entity purchases an additional facility that is leased only to unrelated parties. The value of the new facility is significant to Lessor Entity, and the mortgage on the additional facility requires a guarantee by Manufacturing Entity. Under these circumstances, Manufacturing Entity failed to meet criterion (c) in paragraph 810-10-15-17A to qualify for the accounting alternative when the guarantee is executed and leasing activity with unrelated parties commenced. Manufacturing Entity is engaging in substantial activity outside its leasing activity with Lessor Entity by providing a guarantee on a mortgage secured by an asset that is not being leased by Manufacturing Entity. Not meeting the criteria to qualify for the accounting alternative does not automatically result in consolidation. Instead, Lessor Entity will need to be evaluated under this Topic, including VIE guidance, for consolidation and related disclosure requirements.
Example C: Common Control Leasing Arrangement with Additional Activities Other Than Leasing or for the Support of Leasing

Lessor Entity manufactures cosmetics products in another facility that is unrelated to the operations of Manufacturing Entity. There is no mortgage associated with this additional facility, and Manufacturing Entity does not provide collateral or guarantee any obligations related to the cosmetics business. In this Example, Manufacturing Entity meets all four criteria in paragraph 810-10-15-17A and, as a result of its elected accounting policy, would apply the accounting alternative to Lessor Entity based on the following:

a. Manufacturing Entity and Lessor Entity are under common control.
b. Manufacturing Entity has a lease arrangement with Lessor Entity.
c. Substantially all the activities between Manufacturing Entity and Lessor Entity are related to the lease of the manufacturing facility to Manufacturing Entity.
d. The value of the manufacturing facility leased by Manufacturing Entity exceeds the principal amount of Lessor Entity’s mortgage at inception of the mortgage. There is no obligation associated with the purchase of the cosmetic facility.

If there is a mortgage on Lessor Entity’s cosmetics facility that requires Manufacturing Entity to provide collateral and/or a guarantee, then Manufacturing Entity may not apply this accounting alternative to the Lessor Entity because it would not meet criterion (c) in paragraph 810-10-15-17A. A purchase of cosmetics from Lessor Entity by Manufacturing Entity also would require an evaluation of whether criterion (c) of paragraph 810-10-15-17A is met. Not meeting the criteria to qualify for the accounting alternative does not automatically result in consolidation. Instead, Lessor Entity will need to be evaluated under this Topic, including VIE guidance, for consolidation and related disclosure requirements.