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Ms. Susan M. Cospers  
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**Re: Proposed Accounting Standards Update, *Applying Variable Interest Entity Guidance to Common Control Leasing Arrangements* (File Reference No. PCC-13-02)**

Dear Ms. Cospers:

As the auditor of more than 3,000 private entities, we appreciate the opportunity to comment on the Proposed Accounting Standards Update, *Applying Variable Interest Entity Guidance to Common Control Leasing Arrangements* (the proposed Update) of the Private Company Council (PCC) and the Financial Accounting Standards Board (FASB or Board).

We support providing relief to private companies under US GAAP while continuing to provide relevant information for users of private company financial statements. We also support the Board's overall objective in this proposed Update of allowing private companies to simplify their accounting for certain common control leasing arrangements. Further, we support the Board's commitment to consider whether proposed alternatives for private companies should be applied by public business entities.

We agree that the proposal to permit private companies to avoid applying the variable interest entity guidance (the VIE Model) to common control leasing arrangements when certain criteria are met would achieve the desired result of excluding the effects of a lessor entity's financial position and operating results from a lessee's financial statements.

However, our experience suggests that the same objective may be achieved by clarifying the example in the Codification on the application of the VIE Model. As a result, we believe the primary beneficiary alternative described in BC17 of the proposed Update would address the concerns raised by private company stakeholders. In addition, we believe the primary beneficiary alternative would have more widespread application because it could be applied by all companies, including those that either do not qualify for or do not elect to apply the proposed Update. Also, this alternative would mitigate the potential risk that a private company could elect to apply the proposed Update to avoid consolidating a significant lessor entity in which it otherwise has a controlling financial interest (as defined under the VIE Model).

In addition, we encourage the Board to carefully consider the possible effects of the Board's leases accounting project on the proposed Update. In the Summary and Questions for Respondents of the proposed Update, the Board observed that certain private company financial statement users asked the PCC to take on this project because they do not believe it is meaningful for a lessee to consolidate certain lessor entities that are under common control. Among other things, these users believe the inclusion of a lessor entity's assets and liabilities in a lessee's financial statements would distort their evaluation of the tangible worth of the lessee. However, we note that the Board's leases proposal generally would require lessees (including private companies) to recognize lease-related assets and liabilities on their balance sheets, which in many cases may have a similar effect. Because the leases proposal would unwind some of the perceived benefits of this proposed Update, we recommend that the Board take that proposal into consideration as it completes this project.

If the Board moves forward with this proposal (rather than with the primary beneficiary alternative described in BC17 of the proposed Update), we believe that certain aspects of the proposed Update should be modified to facilitate its implementation. We summarize our more significant concerns below.

#### **Reliance on the term "common control" and lack of clarity with certain other terms**

To be eligible for the relief in the proposed Update, the private company would have to be under "common control" with the lessor entity. Because common control is not defined in US GAAP, it may not always be clear whether a private company and a lessor entity are under common control. We recommend the Board consider replacing this criterion with a simpler, more practical alternative. For example, the criterion could state that this scope exception applies when both the private company and the lessor entity have a common parent, as determined by ASC 810's Voting Interest Model (e.g., both entities have a common majority equity owner).

With respect to other proposed eligibility criteria, we also observe that the meaning of the terms "leasing arrangement" and "supporting leasing activities" are not defined and these terms may be interpreted in various ways. We therefore recommend that the Board clearly define these terms and provide implementation examples. We believe that the Board should define the term "leasing arrangement" as an arrangement that contains a lease that is within the scope of ASC 840. We also encourage the FASB to consider whether this proposal may be affected by possible changes to the scope of ASC 840 through its separate leases accounting project.

We explain these concerns further in the Appendix to this letter, where we provide our detailed responses to the Board's specific Questions for Respondents. Refer to our responses to Questions 4 and 5.

#### **Circumstances when a lessor entity has a business activity unrelated to the lessee entity**

We believe the proposed Update should include a criterion that would require substantially all of the lessor entity's activities to consist of either leasing to the lessee or the support of leasing to the lessee. We are concerned that the proposed Update, as written, would allow a private company to avoid consolidating significant operations in which it has a controlling financial interest by including them in an entity with which it has a leasing arrangement. Including a criterion that would require substantially all of the lessor entity's activities to consist of either leasing to the private company or the support of leasing to the private company would mitigate this possible form of abuse.

We explain this concern further in our response to Question 4 in the Appendix to this letter.

#### **Removing the example of an implicit variable interest**

We are concerned that the proposed Update would remove the example of an implicit variable interest as codified in ASC 810-10-55-87 through 55-89. If the example is removed, there would be no examples in ASC 810 on applying the VIE model's guidance for identifying implicit variable interests. This concept can be challenging to apply and this example is one that is often considered in a variety of circumstances, by both private companies and public business entities. If the Board removes the example, it would be helpful for the Board to provide its reasoning in the Basis for Conclusions. We are concerned that removing the example may imply that this proposal is making fundamental changes to the VIE model for all entities, which we do not understand to be the FASB's intent.

We explain this concern further in our response to Question 12 in the Appendix to this letter.

#### **Transition requirements when companies transition to or from being public business entities**

It is unclear how a private company that elects the proposed alternative would account for eligible arrangements when transitioning to being a public business entity. Transition questions also could arise when public business entities become private companies and want to avail themselves of the relief provided in this proposed ASU. We believe the Board should specifically address the transition requirements in both these circumstances in this or a related project.

\* \* \* \* \*

We would be pleased to discuss our comments with the PCC, the Board or the FASB staff at your convenience.

Very truly yours,



**Responses to the Questions for Respondents in the Proposed Accounting Standards Update, *Applying Variable Interest Entity Guidance to Common Control Leasing Arrangements*, a proposal of the Private Company Council**

This Appendix includes our responses to questions addressed to all respondents or specifically to auditors. We have not responded to questions addressed only to preparers or users. Our responses to Questions 1-11 assume that the Board will proceed with issuing the proposed ASU, rather than proceeding with the primary beneficiary alternative described in BC17 of the proposed Update that we prefer.

**Question 1:** Please describe the entity or individual responding to this request. For example:

- a. Please indicate whether you primarily are a preparer, user, public accountant or, if other, please specify.
- b. If you are a preparer of financial statements, please indicate whether your entity is privately held or publicly held and describe your primary business and its size (in terms of annual revenue, the number of employees, or other relevant metric).
- c. If you are a public accountant, please describe the size of your firm (in terms of number of partners or other relevant metric) and indicate whether your practice focuses primarily on public entities, private entities, or both.
- d. If you are a user of financial statements, please indicate in what capacity (for example, lender, investor, analyst, or rating agency) and whether you primarily use financial statements of private entities or those of both private entities and public entities.

Ernst & Young LLP is one of the largest firms auditing both public and private entities. We currently audit approximately 3,000 private entities, ranging from small start-ups and family-owned enterprises to large privately held multinational corporations.

**Question 2:** Do you agree that the accounting alternative in the proposed Update should apply to all entities except public business entities, not-for-profit entities, or employee benefit plans within the scope of Topics 960 through 965 on plan accounting? If not, what type of entities should not be included in the scope of this accounting alternative?

We agree that this scope exception should apply to all entities except public business entities, not-for-profit entities, or employee benefit plans within the scope of Topics 960 through 965 on plan accounting.

We also encourage the FASB to complete its Proposed Accounting Standards Update, *Definition of a Public Business Entity*, before issuing this proposed Update.

**Question 3:** Do you agree that the proposed Update does not apply to public business entities and employee benefit plans because they lack the arrangements that the accounting alternative addresses? If not, please describe the arrangements that exist for those types of entities that the Board should consider in determining whether any public business entities or employee benefit plans should be included in the scope of the proposed accounting alternative.

We are aware that certain public business entities have leasing arrangements similar to those addressed by the proposed Update. This is among the reasons we prefer the primary beneficiary alternative described in BC17 and are concerned about removing the example of an implicit variable interest from the Codification (refer to our response to Question 12).

We would have concerns about extending the proposed alternative to public business entities without changes to the eligibility criteria, as described in our responses to Questions 4 and 5. However, if the Board moves forward with the proposed Update, we recommend the Board conduct further outreach as to whether extending the proposed alternative to public business entities may be appropriate given the diverse needs of the users of their financial statements.

We are not aware of any employee benefit plans that have these arrangements.

**Question 4:** Do you agree with the required criteria for applying the proposed accounting alternative? If not, please explain why.

To be eligible for the proposed relief, the private company would have to be under "common control" with the lessor entity. As discussed in our cover letter, because common control is not defined in US GAAP, it may not always be clear whether a private company and a lessor entity are under common control. Inconsistent interpretation of the common control evaluation may result in diversity in practice. Further, a private company may need to perform a consolidation analysis to identify the controlling party and determine whether the entities involved in the arrangement are under common control. Any such analysis may require applying the VIE Model to the arrangement, which would mean that the private company would not get the relief intended by the proposed ASU.

We recommend the Board consider replacing this criterion with a simpler, more practical alternative. For example, the criterion could state that this scope exception applies when both the private company and the lessor entity have a common parent, as determined by ASC 810's Voting Interest Model (e.g., both entities have a common majority equity owner).

Also as discussed in our cover letter, we observe that the meaning of the terms "leasing arrangement" and "supporting leasing activities" are not defined and these terms may be interpreted in various ways. We therefore recommend that the Board clearly define these terms and provide implementation examples. We believe that the Board should define the term "leasing arrangement" as an arrangement that contains a lease that is within the scope of ASC 840. We also encourage the FASB to consider whether this proposal may be affected by possible changes to the scope of ASC 840 through its separate leases accounting project. With respect to the term "supporting leasing activities," see our response to Question 5.

Finally, as discussed in our cover letter, we believe the proposed Update should include a criterion that would require substantially all of the lessor entity's activities to consist of either leasing to the lessee or the support of leasing to the lessee. We are concerned that the proposed Update, as written, would allow a private company to avoid consolidating significant operations in which it has a controlling financial interest by structuring them to be included in an entity with which the private company has a leasing arrangement.

To understand our concern, consider the following example, which illustrates how a private company could structure a transaction to avoid consolidation. Assume a private company leases an asset from a lessor entity and they have a common "parent" as another entity holds a majority of the equity interests of both the private company and the lessor entity. Assume the lessor entity holds 20 assets and leases the other 19 assets to unrelated parties. Further, the lessor entity has a substantial amount of bank debt that is guaranteed by the private company. The private company has the power to make all of the significant decisions of the lessor entity, which is embedded in the guarantee that is provided.

Under current US GAAP, the lessor entity would be a variable interest entity (VIE) because power comes through the guarantee and not through equity. Further, the private company would be the primary beneficiary of the VIE because it has the power to make the significant decisions and is exposed to losses that could potentially be significant to the VIE through its guarantee. Therefore, under current US GAAP, the private company would be required to consolidate the VIE. However, by electing to apply the proposed Update, the private company could avoid consolidation and keep the VIE's assets and debt off its balance sheet.

In another example, a private company could transfer significant loss-generating activities to a lessor entity with a common majority owner and avoid consolidation under the proposal, even when it has a controlling financial interest in the lessor entity through a guarantee.

In both these situations, we believe the private company should apply the VIE Model and consolidate the VIE. Including a criterion that would require substantially all of the lessor entity's activities to consist of either leasing to the private company or the support of leasing to the private company would mitigate these potential forms of abuse.

**Question 5:** Do you agree that paragraph 810-10-55-9, which describes the effects of guarantees and joint and several liability arrangements related to a mortgage on the lessor's assets, provides sufficient guidance to clarify what constitutes a supporting leasing activity for applying paragraph 810-10-15-17A(c)? If not, please explain why.

As discussed in our cover letter, we are concerned that the meaning of the term "supporting leasing activities" is not well defined, and this term may be interpreted in various ways. It isn't clear to us how this criterion would be applied when evaluating certain provisions that could exist in common control leasing arrangements. For example, it isn't clear how a private company would evaluate:

- ▶ Off-market lease terms
- ▶ A lessee's residual value guarantee of the leased property

- ▶ A lessee's option to purchase the lease property
- ▶ A lessee's guarantee of the common owner's investment in the lessor entity (instead of a direct guarantee of the lessor entity's bank debt)
- ▶ An agreement by the lessee to incur certain costs on behalf of the lessor entity, including property taxes, insurance, and repair and maintenance expenses

We recommend that the Board clearly define this term and provide implementation examples.

**Question 6:** Do you agree that the following additional disclosures about lessor entities should be provided if a private company elects the proposed accounting alternative? If not, please explain why.

- a. The key terms of the leasing arrangements
- b. The amount of debt and/or significant liabilities of the lessor entity under common control
- c. The key terms of existing debt agreements of the lessor entity under common control (for example, amount of debt, interest rate, maturity, pledged collateral, and guarantees)
- d. The key terms of any other explicit interest related to the lessor entity under common control.

Should other disclosures be required as a result of applying this alternative?

We are concerned that certain of the proposed disclosure requirements could be burdensome to apply and may be redundant with other disclosure requirements (for example, disclosure requirements for related party relationships in ASC 850-10-50). We also encourage the Board to consider whether these requirements may overlap with disclosure requirements in the leases proposal.

However, if the Board moves forward with the proposed Update, we believe that some form of the disclosure requirements currently in ASC 810-10-50-5Ac and 50-5Ad should apply to these arrangements.

We also have the following questions about certain terms. In item b, we are not sure what "significant liabilities" refers to and believe this term could be interpreted and applied in various ways. We likewise are not sure which interests are being referred to in item d. For example, if substantially all of the activities between the lessee and lessor entity relate to the lease or supporting leasing activities (i.e., proposed criterion c.), it seems that "any other explicit interest related to the lessor entity" would be immaterial and therefore would not be disclosed.

**Question 7:** Do you agree that, generally, the primary purpose of establishing a separate lessor entity in a private company setting is for tax and estate-planning purposes and not to structure off-balance-sheet debt arrangements? If not, please explain why.

Given the differences in the size and sophistication of private companies, we believe it is difficult to assert that the primary purpose of establishing a separate lessor entity in a private company setting is for tax and estate-planning purposes.

**Question 8:** Would the proposed accounting alternative, including the required disclosures, address private company stakeholder concerns about relevance of consolidated information without causing a proliferation of the use of lessor entities to avoid reporting assets and liabilities for which the reporting entity is responsible? If not, why?

As noted in our cover letter and in our response to Question 4, under the proposed Update, private companies could structure transactions to avoid consolidating operations in which they may have a controlling financial interest by including those operations in entities with which they have a leasing arrangement that qualifies for the exception. We believe that one possible way to mitigate such structuring opportunities would be for the proposed Update to include a criterion that would require substantially all of the lessor entity's activities to consist of either leasing to the lessee or the support of leasing to the lessee.

**Question 9:** Do you agree that the proposed accounting alternative, when elected, is an accounting policy election that should be applied by an entity to all current and future lessor entities under common control that meet the criteria for applying this approach?

We agree that the proposed Update, when elected, is an accounting policy election that should be applied by an entity to all current and future lessor entities under common control that meet the criteria for applying this approach.

**Question 10:** Do you agree that the proposed accounting alternative should be applied using a full retrospective approach in which financial statements for each individual prior period presented and the opening balances of the earliest period presented would be adjusted to reflect the period-specific effects of applying the proposed amendments?

We agree that the proposed Update should be applied using a full retrospective approach in which financial statements for each individual prior period presented and the opening balances of the earliest period presented would be adjusted to reflect the period-specific effects of applying the proposed amendments.

Also, as addressed in our cover letter, we are uncertain about the transition requirements of this proposed Update when a company transitions to being a public business entity. Further, there are a number of transactions in which public business entities become private companies. The Board should specifically address transition requirements in both these circumstances in this or a related project.

**Question 11:** When should the alternative accounting method be effective? Should early application be permitted?

Because entities would elect the proposed Update, we believe that an effective date in the first period after issuance of a final standard would be appropriate. Further, we would support permitting early application.

**Question 12:** Do you agree that the example that is codified in paragraphs 810-10-55-87 through 55-89 (described in paragraphs BC19 through BC20 of this proposed Update) should be removed? Do you agree that the removal of the example would not significantly affect public business entity stakeholders? If not, please explain why.

As discussed in the cover letter, we are concerned about removing the example of an implicit variable interest as codified in ASC 810-10-55-87 through 55-89. If the example is removed, there would be no examples in ASC 810 on applying the VIE model's guidance for identifying implicit variable interests. This concept can be challenging to apply and this example is one that is often considered in a variety of circumstances, by both private companies and public business entities.

We note that the example would remain useful to companies that are not eligible for, or do not elect to apply, the proposed Update. Therefore, we believe it should not be removed. Even if the Board moves forward with the proposed Update, we believe the example could be retained and improved, as described in the primary beneficiary alternative in BC17.

If the Board removes the example, it would be helpful for the Board to provide its reasoning in the Basis for Conclusions. We are concerned that removing the example may imply that this proposal is making fundamental changes to the VIE model for all entities, which we do not believe is the FASB's intent.

We also noted that the amendments in the proposed Update include removing paragraph 810-10-25-48. It is unclear why this paragraph would be removed since it would still apply to entities that do not qualify for, or do not elect to apply, the proposed Update. If this paragraph is removed, the Board should explain its reasoning in the Basis for Conclusions. We are concerned that removing this paragraph may imply that the proposed Update is making fundamental changes to the VIE model for all entities, which we do not believe is the FASB's intent.

**Question 13:** The PCC considered two other alternatives (as described in paragraphs BC15 through BC18 of this proposed Update) to clarify the application of VIE guidance to common control leasing arrangements.

- a. Would either of those alternatives better address the concerns raised by private company stakeholders?
- b. Should the PCC and the Board consider either of those alternatives in conjunction with the guidance in this proposed Update to better address the concerns raised by private company stakeholders?

We considered these two alternatives. We do not believe that the variable interest alternative described in BC15 of the proposed Update would better address the concerns raised by private company stakeholders. We are concerned that the alternative may be misleading, and could result in a private company's failing to identify an implicit variable interest when one may exist. For example, the lessor entity may be exposed to other variability, in addition to the variability associated with the lessee's credit risk. The lessor entity may be exposed to variability associated with changes in the fair value of the leased asset (which may not always be affected by actions of the lessee) and to the credit risk of the owner, in circumstances when the owner also provides a guarantee. A lessee providing an implicit guarantee may be exposed to all of these forms of variability, which could be significant. In these circumstances, we believe it would be appropriate to conclude the lessee has an implicit variable interest.

However, we believe that the primary beneficiary alternative described in BC17 of the proposed Update would better address the concerns raised by private company stakeholders. As explained in our cover letter, we prefer this alternative. We believe the primary beneficiary alternative would have more widespread application because it could be applied by all companies, including those that either do not qualify for, or do not elect to apply, the proposed Update. Also, this alternative would mitigate the risk that a private company could elect to apply the proposed Update to avoid consolidating a significant lessor entity in which it has a controlling financial interest (as defined under the VIE Model).

We also believe this project presents an opportunity to clarify guidance currently in paragraph ASC 810-10-25-54, which we believe creates some confusion in practice on how to apply the VIE Model to determine the primary beneficiary when a reporting entity holds an implicit variable interest in an entity. Following is an excerpt from the paragraph (emphasis added):

*A reporting entity that holds an implicit variable interest in a VIE and is a related party to other variable interest holders shall apply the guidance in paragraph 810-10-25-44 to determine whether it is the primary beneficiary of the VIE. That is, if the aggregate variable interests held by the reporting entity (both implicit and explicit variable interests) and its related parties would, if held by a single party, identify that party as the primary beneficiary, then the party within the related party group that is most closely associated with the VIE is the primary beneficiary.*

We believe this excerpt may be interpreted by some to mean that when an entity holds an implicit variable interest and is a related party to other variable interest holders, it should skip determining whether it or any of the other variable interest holders *individually* is the primary beneficiary and go straight to determining which party in the related party group is most closely associated with the lessor entity.

We do not believe this is how the Board intends for the VIE Model to be applied to implicit variable interests, even those involving common control relationships. That is, we believe ASC 810-10-25-44 is clear that under the VIE Model, a reporting entity must first determine whether it or any of the other variable interest holders *individually* is the primary beneficiary. The VIE Model's provisions on determining which party in a related party group is the primary beneficiary is applied only after it is determined that no variable interest holder individually has the characteristics of a primary beneficiary.

If the FASB moves forward with the proposed Update, we recommend amending paragraph ASC 810-10-25-54. We have included an excerpt from ASC 810-10-25-54 with our proposed clarifying amendments for the Board's consideration (see underlined text):

A reporting entity that holds an implicit variable interest in a VIE and is a related party to other variable interest holders shall apply the guidance beginning in paragraph 810-10-25-38A to determine whether it is the primary beneficiary of the VIE. That is, if a reporting entity concludes that neither it nor one of its related parties has the characteristics in paragraph 810-10-25-38A but instead concludes that the aggregate variable interests held by the reporting entity (both implicit and explicit variable interests) and its related parties would, if held by a single party, identify that party as the primary beneficiary, then the party within the related party group that is most closely associated with the VIE is the primary beneficiary.