March 20, 2014

FASB In Focus

Accounting Standards Update—*Applying Variable Interest Entities Guidance to Common Control Leasing Arrangements*

Background

On March 20, 2014, the Financial Accounting Standards Board (FASB) issued guidance that provides private companies with an alternative to U.S. generally accepted accounting principles (GAAP) in applying variable interest entities (VIEs) guidance to certain common control leasing arrangements.

Specifically, the new guidance removes the requirement to apply VIE guidance for common control leasing arrangements when certain conditions are met. The update is a consensus of the Private Company Council (PCC) that was endorsed by the FASB.

The FASB and the PCC believe that the disclosures under FASB Accounting Standards Update No. 2014-07, *Applying Variable Interest Entities Guidance to Common Control Leasing Arrangements* provide useful information to users of private company financial statements without the cost and complexity of applying VIE guidance.

A *variable interest entity* is an entity for which a consolidation assessment is not based on a majority of voting rights.

How Would the Alternative Improve Financial Reporting?

Under current U.S. GAAP, a company is required to consolidate the financial reporting from an entity in which it has a controlling financial interest.

Under the voting interest model, the principle for a controlling financial interest is ownership of a majority of an entity's voting interests.

Under the VIE model, a company preparing financial statements is deemed to have a controlling financial interest (that is, deemed to be the primary beneficiary) when it has both (a) the power to direct the activities that most significantly affect the economic performance of the entity, and (b) the obligation to absorb losses or the right to receive benefits of the entity that could be potentially significant to the entity.

To determine which model applies, a company preparing financial statements must first determine whether it has a variable interest in the entity being evaluated for consolidation and whether that entity is a VIE.

Under the amendments in this Update, a private company could elect, when certain conditions exist, not to apply VIE guidance to a lessor under common control.

Most users of private company financial statements state that the consolidation of the lessors under common control is irrelevant and distorts the financial statements of the lessee. The Board and the PCC also concluded that the disclosures about the lessor and the leasing arrangement under this alternative provide useful information without the cost and complexity of applying VIE guidance.

The FASB and the PCC believe that the accounting option for applying VIE guidance to common control lessors is responsive to the needs of private companies and that it will continue to provide decision-useful information to the users of private company financial statements, while providing a reduction in the cost and complexity associated with applying VIE guidance. Therefore, the amendments meet the overall objective of the Private Company Decision-Making Framework for addressing the needs of private company stakeholders.

An Example: Common Control Leasing Arrangement

A company preparing financial statements (lessee) leases a facility from a lessor, which is owned by one of the lessee's two owners and has the facility as its only asset.

The lease, with market terms, is the only contractual relationship between the two companies.

Furthermore, the lease contains no other explicit arrangements such as a guarantee of the residual value or a purchase option of the leased asset.

U.S. GAAP requires the lessee in such circumstances to consider whether it holds a variable interest, for example, a guarantee of the lessor's debt. If a lessee holds a variable interest (explicit or implicit) in the lessor and determines that the lessor is a VIE, then the lessee must assess whether it holds a controlling financial interest in the lessor.

As a result, a lessee, in certain circumstances, may be required to consolidate a lessor when they are under common control.

This is an example of when a private company would have to apply VIE guidance. The alternative allows one to not apply VIE guidance when certain conditions are met.

Why Is the FASB Issuing This Exposure Draft?

The Private Company Council (PCC) added this issue to its agenda in response to feedback from private company stakeholders who believe that the benefits of applying VIE guidance to a lessor under common control do not justify the related costs.

For example, many lenders told the PCC and the FASB that they do not find consolidating a lessor under common control with a lessee to be useful.

Other stakeholders noted that, generally, a common owner establishes a lessor separate from the private company lessee for tax, estate-planning, and/or legal-liability purposes—not to structure off-balance-sheet debt arrangements.

Many stakeholders also said they find VIE guidance to be costly and complex to implement and often the application of VIE guidance requires the assistance of outside specialists at a significant cost.

Additionally, in instances in which a lessor is consolidated based on VIE guidance, most users of private company financial statements stated that consolidation is not relevant to them. This is because they focus on the cash flows and tangible worth of the standalone reporting lessee, not the cash flows and tangible worth of the consolidated group as presented under U.S. GAAP.

These users stated that consolidation of the lessor distorts the financial statements of the lessee. Consequently, users who receive consolidated financial statements often request a consolidating schedule to enable them to reverse the effects of consolidating the lessor.

Based on the FASB's Private Company Decision-Making Framework (Guide), which emphasizes user-relevance considerations for private companies, the PCC decided that the concerns expressed would justify a change to VIE guidance.

What Are the Main Provisions?

The amendments permit a private company lessee to elect an alternative not to apply VIE guidance to a lessor when:

a. The private company lessee and the lessor are under common control,

b. The private company lessee has a leasing arrangement with the lessor,

c. Substantially all of the activity between the private company lessee and the lessor is related to the leasing activities (including supporting leasing activities) between those two companies, and

d. If the private company lessee explicitly guarantees or provides collateral for any obligation of the lessor related to the asset leased by the private company, then the principal amount of the obligation at inception does not exceed the value of the asset leased by the private company from the lessor.

If elected, the accounting alternative should be applied to all leasing arrangements meeting the above conditions. For example, such leasing activities can include the issuance of a guarantee and providing collateral on the obligations related to the asset(s) of the lessor leased to the private company lessee.

Under the alternative, a private company lessee would not be required to provide the VIE disclosures about the lessor. Rather, the private company lessee would disclose (a) the amount and key terms of liabilities recognized by the lessor that expose the private company lessee to providing financial support to the lessor and (b) a qualitative description of circumstances not recognized in the financial statements of the lessor that expose the private company lessee to providing financial support to the lessor.

The disclosures under this alternative are required to be disclosed in combination with the disclosures required by other topics (for example, Topic 460, Guarantees, Topic 840, Leases, and Topic 850, Related Party Disclosures) about the lessor. The disclosures could be made by aggregating all disclosures in a single note or by including cross-references within the notes to financial statements.

The alternative applies to all private companies and would exclude public companies, not-for-profit organizations, and employee benefit plans within the scope of Topics 960 through 965 on plan accounting.

Under current GAAP, not-for-profit organizations already are substantially excluded from the scope of VIE guidance.

Finally, companies that elect this alternative should continue to apply consolidation guidance other than VIE guidance in Topic 810 as well as other applicable guidance, including Topic 460, Guarantees, and Topic 840, Leases.

When Will the Amendments Be Effective?

If a private company elects to use this accounting alternative, the alternative should be applied retrospectively to all periods presented. The alternative will be effective for annual periods 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 company's annual or interim financial statements have not yet been made available for issuance. More information on the standard, including a press release and a video, is available on the FASB website and the PCC website.■

For more information on the project, please visit the FASB website at www.fasb.org or the PCC website at www.fasb.org/pcc.

The views expressed in this document do not necessarily reflect the views of the FASB. Official positions of the FASB are arrived at only after extensive due process and deliberation.

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