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Ms. Susan M. Cosper
Technical Director
File Reference No. 2017-240
Financial Accounting Standards Board
401 Merritt 7
P.O. Box 5116
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31 August 2017

Re: Proposed Accounting Standards Update, *Consolidation (Topic 810): Targeted Improvements to Related Party Guidance for Variable Interest Entities* (File Reference No. 2017-240)

Dear Ms. Cosper:

We appreciate the opportunity to comment on the Proposed Accounting Standards Update (ASU), *Consolidation (Topic 810): Targeted Improvements to Related Party Guidance for Variable Interest Entities* issued by the Financial Accounting Standards Board (FASB or Board).

We support the FASB's objective of reducing complexity when applying the variable interest entity (VIE) guidance in common control situations. We believe that one of the primary contributors to the perceived complexity and challenges in applying consolidation accounting is that Accounting Standards Codification (ASC) 810 has two models (voting and variable interest) to determine whether one has a controlling financial interest. This issue has been fully exacerbated by the number of times that consolidation accounting has been revised in recent years. As a result, we continue to believe that financial reporting would be best served by the FASB creating a single comprehensive consolidation model, which would reduce cost and complexity for all companies.[1]

To the extent the FASB moves ahead with targeted changes to the model proposed at this time, we support aligning the treatment of indirect interests held through related parties in determining whether fees paid to decision makers and service providers are a variable interest with the treatment of these interests for the purpose of determining the primary beneficiary. However, we believe the FASB should reconsider its proposals to create a new private company accounting alternative (PCAA) and to remove the "related party tie-breaker" test.

We agree with the FASB's objective of reducing the cost and complexity of financial reporting while improving or maintaining the usefulness of the information provided to financial statement users. However, we do not support the creation of a new PCAA, because it provides the opportunity for abuse through structuring as discussed in our response to Questions 1 and 2 and Example 1. We also believe

[1] See Ernst & Young LLP Comment Letter 48, *Consolidation (Topic 810): Principal versus Agent Analysis* (File Reference No. 2011-220) for more detail on our views.

that consolidation is fundamental to financial statement presentation and that public and private companies should consistently recognize and measure interests in other entities. Additionally, it could result in greater diversity than current guidance because it provides private companies with an accounting policy choice, which may be elected by some companies and not others. Rather, we recommend adding examples to illustrate the application of certain concepts that seem to be the most challenging for private companies to apply, as discussed in more detail in our response to Questions 1 and 2.

With respect to the related party tie-breaker test, we believe the removal would eliminate an important anti-abuse provision that was established when the Board issued *FASB Interpretation No. 46: Consolidation of Variable Interest Entities* (FIN 46(R)). In addition, if the Board believes that there is currently diversity in practice, we believe that diversity could be reduced by stating which of the existing four factors in the related party tie-breaker test should be weighted most heavily. If the Board proceeds with its proposal, we believe that greater clarity is needed both with respect to the objective when evaluating circumstances in which a related party group has the characteristics of a controlling financial interest, as well as how the factors would be applied in illustrative examples so preparers and auditors can apply the guidance on a consistent basis. Without additional clarification and illustrative examples, we believe the proposal will potentially result in greater diversity in application under the proposal than under current guidance.

We encourage the Board to consider these and other concerns we raise in the appendix to this letter, where we answer the questions posed in the proposal.

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

Very truly yours,

Ernst + Young LLP

Appendix

We are not responding to Questions 10 through 12 because we have no further comments on those questions.

> **Question 1:** Should all common control arrangements (that is, for both private companies and public business entities) be excluded from the scope of VIE guidance (as opposed to just an option for private companies as provided in the amendments in this proposed Update)? Please explain.
>
> **Question 2:** Do you agree that a private company (reporting entity) should have an option to not apply VIE guidance to legal entities under common control if both the common control parent and the legal entity being evaluated for consolidation are not public business entities? If not, please explain why.

Our responses to Questions 1 and 2 are combined below.

The potential for abuse

We do not believe that any common control arrangements should be excluded from the scope of the VIE guidance, due to our concerns about the potential for abuse. We are concerned that the proposal, as written, would allow a private company to elect the scope exception and avoid consolidating significant operations by transferring them into a legal entity and creating a structure that separates power and benefits. A reporting entity could transfer significant loss-generating activities to a legal entity with which it has a common majority owner and avoid consolidation of the legal entity using the Voting Model (see Example 1). While the ultimate parent would consolidate the legal entity under the proposal if it issues financial statements, which may not be the case, we do not believe that this provides transparency to the operations of the underlying subsidiary by the reporting entity.

We do not believe disclosures would provide an adequate substitute to consolidation for the users of the reporting entity's financial statements. In the Background Information and Basis for Conclusions E34 in FIN 46(R), the Board stated "additional disclosures are not a replacement for proper recognition and measurement." In our view, the proposed ASU may result in differences in recognition and measurement that disclosures would not be able to sufficiently supplement.

For the same reasons, we do not believe that public companies should have the option not to apply VIE guidance to legal entities under common control. As noted in our cover letter, we believe that consolidation is fundamental to financial statement presentation and that public and private companies should consistently recognize and measure interests in other entities.

The potential for diversity in practice

Furthermore, we do not believe that the current guidance results in "diversity in practice" in the application of the Variable Interest Model. In fact, we believe there is risk of greater diversity under the proposal than under current guidance because it provides an accounting policy choice. Additionally, we have not observed a "lack of formality in private company arrangements under common control" as described in BC13 and BC14 of the proposed ASU. Based on our understanding of the outreach performed by the FASB staff, some of the perceived diversity in practice may have an element of "implied power." In response, we would observe that while only substantive terms should be considered under the Variable Interest Model, the FASB rejected the notion of implied power or de facto control when it was deliberating the exposure draft prior to the issuance of ASU 2015-02. Thus, private reporting entities should not consolidate legal entities under the basis of implied power. That is, we believe that this perceived diversity in practice may stem from a misunderstanding of the principles in the current Variable Interest model. See our proposed solution below.

In evaluating these points, our experience is gained from auditing over 2,000 private entities in the US, ranging from small start-ups and family-owned enterprises to large privately held multinational corporations.

Proposed solution

The issues raised by the FASB could be addressed by our alternative solutions of (1) developing a single model or (2) adding an illustrative example. This example should illustrate two principles in the current Variable Interest model that may be misunderstood by preparers: (1) power must be explicit, not implicit and (2) if any party individually (such as a sole owner) has power and benefits over a VIE, that party would consolidate before other parties apply the current related party tie-breaker test. As we discussed in our comment letter to PCC-02, we believe that extending the example that was previously in ASC 810-10-55-87 through 55-89 to include the identification of the primary beneficiary would have resolved the concerns noted by preparers (see Example 2 for our proposal).

Other concerns

To be eligible for the proposed relief, the private company reporting entity would have to be under common control with the legal entity. Because common control is not defined in US GAAP, companies could reach different conclusions about whether they are under common control in similar circumstances. Today, we believe that common control considers both the Variable Interest Model and the Voting Model. However, it is unclear in the proposal whether a reporting entity should consider the Variable Interest Model when assessing common control, and if so, whether that would provide the intended relief for those private companies.

If a reporting entity elects the PCAA (or all entities, if the scope were extended), the common control parent(s) would be required to consolidate the legal entity if, through its commonly controlled interests, it has a controlling financial interest in the legal entity, unless a scope exception applies. In a multi-tiered private company, we believe it could be operationally challenging for the parent(s) to identify and consolidate such entities when a parent does not have a variable interest in the legal entity. Areas that could be difficult include accounting for income taxes and foreign currency translation, and intercompany eliminations. These challenges are likely to be more significant in public company structures.

Lastly, the proposed alternative may not provide the intended relief to certain private companies, because if they or their common control parent become a public business entity (PBE), the alternative could no longer be applied. We observe that a company's PBE status sometimes depends on the decisions or performance of its investors, rather than those of the reporting entity itself. This can occur, for example, when an equity method investee meets the definition of a PBE because its financial statements or summarized financial information becomes significant to an investor and is included in a registrant's filing under Rule 3-09 or 4-08(g) of Regulation S-X.

Question 3: Should the current accounting alternative for private company leasing arrangements under common control provided under Update 2014-07 be retained, or should it be replaced by the proposed broader private company alternative, assuming this proposed Update is finalized? Would the proposed accounting alternative continue to address the concerns of private companies currently applying the accounting alternative for leasing arrangements under common control? If not, please explain why. Additionally, what existing leasing arrangements that are eligible to be accounted for using the current alternative, if any, would not be captured by the accounting alternative in the proposed amendments?

As stated above, we do not support a broad PCAA. However, if the FASB believes that a PCAA is necessary, we believe that a single scope exception should encompass all types of variable interests rather than maintaining the existing scope exception for leases and a separate scope exception for all other variable interests.

Question 4: Do the proposed disclosure requirements in paragraphs 810-10-50-2AG through 50-2AI adequately provide information about a reporting entity's involvement with and exposure to a legal entity? If not, please explain why. Also, please elaborate on any additional disclosures that you consider necessary to appropriately reflect a reporting entity's involvement with and exposure to a legal entity.

Consistent with the Board's previous views on this topic, we believe that "additional disclosures are not a replacement for proper recognition and measurement."[2] We recommend that the Board conduct further outreach about whether the proposed disclosure requirements would provide useful information, given the diverse needs of the users of financial statements.

Question 5: Should indirect interests held through related parties that are under common control with a decision maker or service provider be considered on a proportionate basis, as opposed to being considered the equivalent of a direct interest in its entirety, when determining whether a decision-making fee is a variable interest in a VIE? If not, please explain why.

We agree that when a reporting entity is determining whether fees paid to decision makers and service providers are a variable interest in a VIE, indirect interests held through related parties that are under common control with a decision maker or service provider should be considered on a proportionate basis. This change would align this guidance with the treatment of indirect interest for the purpose of determining the primary beneficiary, as required by ASU 2016-17, *Consolidation (Topic 810): Interests Held through Related Parties that are under Common Control*.

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[2] E34 in FIN 46(R).

Question 6: Should a reporting entity be required to determine whether a controlling financial interest exists at the reporting entity level for situations in which power is shared among related parties or when related parties under common control, as a group, have a controlling financial interest but the parties individually do not? If not, please explain why. In doing so it is acknowledged that, in certain situations, it is possible that no reporting entity under common control will consolidate a VIE.

Question 7: Are the factors in paragraph 810-10-25-44A adequate for determining whether a reporting entity within a common control group may be the primary beneficiary of a VIE? If not, please explain why and describe what other factors you would recommend.

Question 8: Does the "related party tie-breaker" test currently in GAAP (paragraph 810-10-25-44) result in appropriate consolidation results? If yes, please explain why. Alternatively, would the proposed amendments cause unintended consequences or allow reporting entities to achieve a desired consolidation result that is inconsistent with the economics of a related party arrangement? If yes, please explain how.

Our responses to Questions 6 through 8 are combined below.

Reasons to retain current GAAP

We believe the "related party tie-breaker" test in US GAAP results in appropriate consolidation conclusions and should be retained. We also agree with the view in BC48 of the proposal that the related party tie-breaker test will be applied less frequently after the adoption of ASUs 2015-02 and 2016-07, which private companies had not yet adopted at the time much of the FASB staff's outreach was conducted. Hence, we do not support the proposed four-factor test for attributing decision-making authority in shared power situations or for related party groups under common control for the reasons stated below.

Under the proposal, the common control parent(s) would be required to consolidate the legal entity if, through its commonly controlled interests, it has a controlling financial interest in the legal entity, unless a scope exception applies. As discussed in our response to Questions 1 and 2, we believe it could be operationally challenging for the parent(s) to identify and consolidate such entities when the parent does not have a variable interest in the legal entity.

The potential for abuse

We also believe the proposed ASU has the potential for abuse, because it would allow companies to create entities and enable an intermediate reporting entity to be structured in a way that would shift its assets and liabilities off balance sheet, which the consolidation guidance is designed to prevent. At times, only the intermediary entities are reporting entities (i.e., the ultimate parent does not produce consolidated financial statements). We agree with the two Board members who expressed similar concerns about removing the current guidance, as described in BC46.

If the Board believes that there is currently diversity in practice, we believe that diversity could best be eliminated by stating which of the existing four factors in the related party tie-breaker test should be weighted most heavily.

Objective of the guidance and the four factors

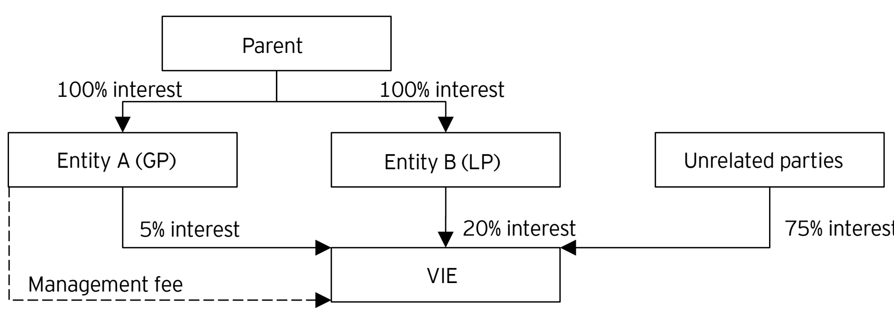
If the Board moves ahead with this aspect of the proposal without any further changes, we believe that different parties could reach different conclusions for the same fact patterns, as shown in Example 3. This may result in diversity in practice. We agree with the two Board members who expressed similar concerns about the four factors, as described in BC47.

To minimize potential diversity in practice, we believe that the Board should clarify its objective for the four factors to attribute decision-making authority and which party or parties should consolidate. We believe the Board should do this by explaining in the Basis for Conclusions how these factors indicate that an entity is a primary beneficiary that should consolidate. The Board also should provide examples of how the four factors would be used to attribute decision-making authority in related party groups. The Board also should address in the guidance whether, and if, one factor should be weighted more heavily than another.

The determination of a controlling financial interest in a related party group

If the Board continues with the proposal, we believe it should clarify the guidance in ASC 810-10-25-44A related to the determinations that are made by parties with direct interests in the VIE. We believe the Board should clarify whether those determinations should be respected when evaluating whether the related party group has a controlling financial interest. The issue that arises can be illustrated in the following example:

> Entity A and Entity B, which are under common control, form a limited partnership that is a VIE. Entity A holds a 5% general partnership equity interest and also receives a fee for decision-making that is commensurate with the services provided and includes only customary terms and conditions. Entity B holds a 20% limited partnership equity interest and the remaining interests are dispersed among other investors.



> The fee is not a variable interest; therefore Entity A would not have power, because it makes all its decisions for the VIE through an arrangement that is not a variable interest. As a result, Entity A would not consolidate the VIE.
>
> On a direct and indirect basis, Entity B has benefits but not power.

One view is that when evaluating whether the related party group has the characteristics of a controlling financial interest, the determinations made individually by each of the parties involved should be respected (historically, this has been referred to as a "bottoms up" approach to consolidation). That is, in the example above, since Entity A and Entity B individually do not have power, then the related party group does not have power.

Another view is that when evaluating whether the related party group has the characteristics of a controlling financial interest, the determinations should be made as to whether the parent has a controlling financial interest, considering all of its direct and indirect interests and rights, including those held indirectly. Under this view, one might conclude that the decision-making authority is power, if the parent has other significant interests in the VIE (such as those held indirectly through Entity B in the example above).

We acknowledge that ASC 810-10-25-44A states that the common control group should include a decision maker within the group that does not have a variable interest. However, we believe that the Board should clarify which of the above views is appropriate and when decision-making that is not held through a variable interest should be considered power such that the related party group has a controlling financial interest (i.e., power and benefits).

Question 9: Do you agree with the proposed transition requirements in paragraph 810-10-65-9? If not, what transition approach would be more appropriate?

It would appear that under the proposed transition guidance, companies that applied ASU 2015-02 retrospectively (to 2013, 2014 and 2015) would have to retrospectively apply this guidance to their 2013 financial statements (or earlier). We believe this would be complex and costly and shouldn't be required. We recommend that the adoption of this proposed ASU be separate from the adoption of ASU 2015-02.

See our response to Question 13 for our concerns about the transition guidance for the PCAA.

Question 13: Should the effective date of the private company accounting alternative be consistent with the amendments in Accounting Standards Update No. 2016-03, Intangibles—Goodwill and Other (Topic 350), Business Combinations (Topic 805), Consolidation (Topic 810), Derivatives and Hedging (Topic 815): Effective Date and Transition Guidance?

Although we do not support creating the PCAA, we believe that, if the Board moves ahead with this alternative, private companies should be able to adopt it at any time without having to assess preferability so they can benefit from the relief it allows. We have concerns that as written, the proposal would require a private company to conduct a preferability assessment upon electing the PCAA after the effective date, which would seem to be difficult and therefore negate the relief that the FASB intended to provide. Therefore, if the FASB proceeds with this proposal, we agree with an approach to adoption similar to the Private Company Council's (PCC) recommendation in ASU 2016-03.

Example 1 — Private company accounting alternative abuse

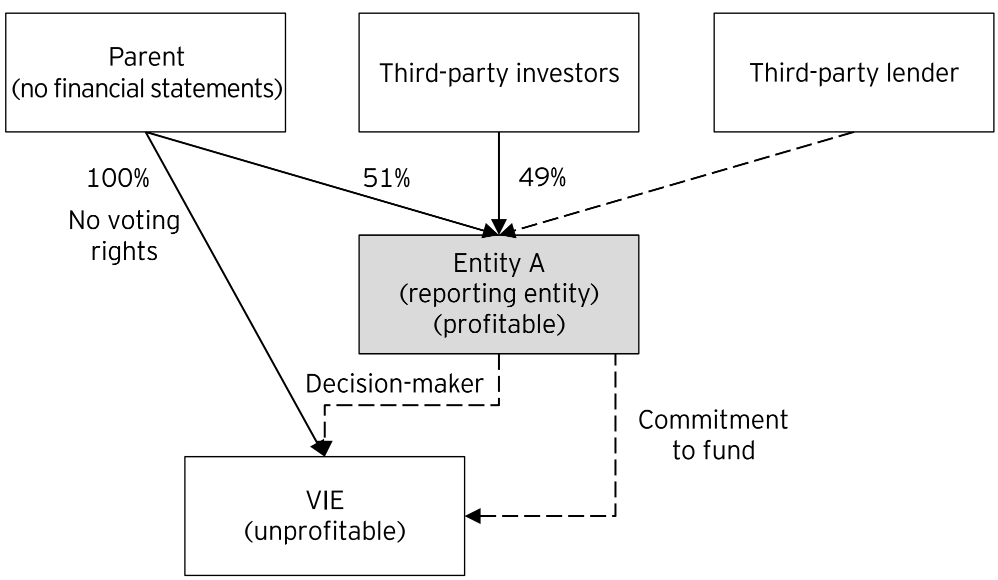
If the FASB moves forward with its proposal, there is potential for a private company (or all entities, if the scope were extended) to avoid consolidating significant operations by transferring them into a legal entity and creating a structure that separates power and benefits. This example illustrates a fact pattern that we believe is indicative of such potential abuse.

Background

Assume the below structure and the following facts:

- Entity A and VIE are under common control of Parent.
- Entity A is profitable and has a commitment to fund the VIE through loans.
- Entity A receives a decision making fee through a contract that is customary and commensurate; however, it is a variable interest because of the commitment to fund the VIE.
- Parent, Entity A and VIE are not public business entities.
- Parent does not issue financial statements.
- VIE is a spin-off of Entity A, has insufficient equity at-risk and is not profitable.

Which entity consolidates VIE?



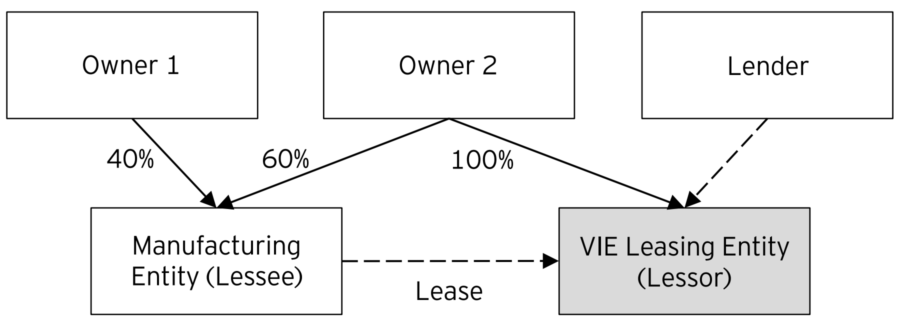
Analysis: Which entity consolidates VIE?		
Selected steps of consolidation model:	**2015-02 and related amendments (Variable Interest Model)**	**Exposure draft private company accounting alternative (Voting Model)**
1. Do any scope exceptions exist?	No	Yes — PCAA
2. If yes, use other consolidation guidance (e.g., Voting Model)	N/A	Greater than 50% voting shareholder — Parent
3. If no, does any entity, on a direct basis have power and benefits?	No	N/A
4. Single decision maker or shared power?	Single	N/A
5. Does any entity, on a direct and indirect basis, have power and benefits?	Entity A	N/A
Consolidating entity:	Entity A (Parent would also consolidate VIE through its consolidation of Entity A, but Parent does not issue consolidated financial statements)	Parent only, but it does not issue consolidated financial statements

We believe this example highlights the potential for abuse. While certain parties (e.g., lender or significant investors) of Entity A may be able to compel Entity A to produce financial statements of the VIE, we believe the non-consolidation of the VIE (and disclosure only of the commitment) by Entity A does not appear to provide general purpose financial statements that are useful to all stakeholders of Entity A.

Example 2 — Our recommended proposal

As noted in our response to Questions 1 and 2, we believe that many of the concerns raised by private companies are due to a lack of understanding of when to apply the current related party tie-breaker test, and whether a concept of implicit power exists. We believe that by adding back the guidance that was previously codified in ASC 810-10-55-87 through 89, and extending that example through the primary beneficiary evaluation, the existing model may be more easily understood and consistently applied by stakeholders. We have illustrated this below.

810-10-55-87 This example illustrates the guidance in paragraphs 810-10-25-48 through 25-54 and the guidance in ASC 810-10-25-38 through 44B.



810-10-55-88 One of the two owners of Manufacturing Entity is also the sole owner of Leasing Entity, which is a VIE. The owner of Leasing Entity provides a guarantee of Leasing Entity's debt as required by the lender. Leasing Entity owns no assets other than the manufacturing facility being leased to Manufacturing Entity. The lease, with market terms, contains no explicit guarantees of the residual value of the real estate or purchase options and is therefore not considered a variable interest under paragraph 810-10-55-39. The lease meets the classification requirements for an operating lease and is the only contractual relationship between Manufacturing Entity and Leasing Entity.

810-10-55-89 Manufacturing Entity should consider whether it holds an implicit variable interest in Leasing Entity. Although the lease agreement itself does not contain a contractual guarantee, Manufacturing Entity should consider whether it holds an implicit variable interest in Leasing Entity as a result of the leasing arrangement and the relationship between it and the owner of Leasing Entity. For example, Manufacturing Entity would be considered to hold an implicit variable interest in Leasing Entity if Manufacturing Entity effectively guaranteed the owner's investment in Leasing Entity. The guidance in paragraphs 810-10-25-48 through 25-54 shall be used only to evaluate whether a variable interest exists under the Variable Interest Entities Subsections and shall not be used in the evaluation of lease classification in accordance with Topic 840. Paragraph 840-10-25-26 addresses leases between related parties. Manufacturing Entity may be expected to make funds available to Leasing Entity to prevent the owner's guarantee of Leasing Entity's debt from being called on, or Manufacturing Entity may be expected to make funds available to the owner to fund all or a portion of the call on Leasing Entity's debt guarantee. The determination as to whether Manufacturing Entity is effectively guaranteeing all or a portion of the owner's investment or would be expected to make funds available and, therefore, an implicit variable interest exists, shall take into consideration all the relevant facts and circumstances. Those facts and circumstances include, but are not limited to, whether there is an economic incentive for Manufacturing Entity to act as a guarantor or to make funds available, whether such actions have happened in similar situations in the past, and whether Manufacturing Entity acting as a guarantor or making funds available would be considered a conflict of interest or illegal.

[Proposed addition to codification]

Further assume the following facts:

- Manufacturing Entity and VIE are under common control of Owner 2.
- Leasing Entity is a VIE.
- VIE's articles of incorporation state that all decisions of the VIE are made by its shareholder, which is Owner 2.
- Manufacturing Entity sometimes advises Leasing Entity on which equipment to buy, recommends vendors and has input into financing terms. However, Manufacturing Entity has no formal decision-making over Leasing Entity (i.e., all involvement in these decisions is at the discretion of Owner 2).
- Although Manufacturing Entity may be expected to make funds available to Leasing Entity to prevent the owner's guarantee of Leasing Entity's debt from being called on, there is no formal arrangement between the entities that gives any decision-making to Manufacturing Entity; i.e., Manufacturing Entity does so based upon directions from Owner 2.
- Owner 2 absorbs the variability of the VIE through its equity interest.

Which entity is the primary beneficiary of the VIE?

Analysis

Regardless of whether Manufacturing Entity is determined to have an implicit variable interest (i.e., benefits) in Leasing Entity, it does not have power over Leasing Entity because it has no decision-making authority over Leasing Entity. The advice it provides into certain decisions for Leasing Entity does not constitute power as Manufacturing Entity has no formal decision making ability.

Owner 2 has power over Leasing Entity through its equity interest, because the articles of incorporation state that all decisions of the VIE are made by its shareholder. In addition, Owner 2 has benefits from Leasing Entity through its equity interest. Therefore, Owner 2 is the primary beneficiary of Leasing Entity.

Because Owner 2 is identified individually as the primary beneficiary (i.e., it has both power and benefits) of Leasing Entity, Manufacturing Entity does not apply the related party guidance in paragraph 810-10-25-42-44B.

Example 3 — Related party tie-breaker evaluation factors (810-10-25-44A)

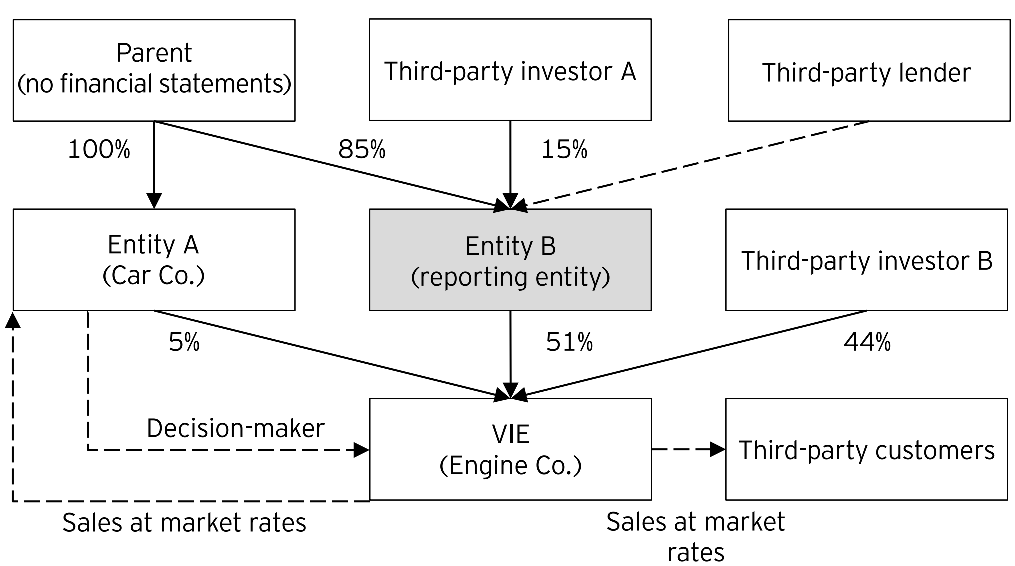
If the FASB moves forward with its proposal, we do not believe that judgment in applying the four factors to the related party tie-breaker test would be consistently applied. This exhibit illustrates a fact pattern that we believe results in two views (consolidate or not) on how to apply the proposed guidance in 810-10-25-44A.

Background

Assume the below structure and the following facts:

- Entity A and Entity B are under common control of Parent.
- Parent does not issue financial statements.
- Engine Co. is a VIE with insufficient equity at-risk and has a significant pension obligation.
- Engine Co.'s purpose is to sell engines; it will sell to Car Co. and also have other significant sales to third-party customers.
- Engine Co. is the sole producer of Car Co.'s engines.
- Entity B is a holding company created to invest in Engine Co.
- Car Co. receives a decision making fee through a contract that is customary and commensurate, (i.e., it is not a variable interest, because Car Co.'s other interests are not expected to absorb more than an insignificant amount of the VIE's expected losses).
- Benefits are derived pro rata through equity.

Does Entity B consolidate the VIE?



Analysis: Should decision-making authority be attributed to Entity B and, therefore, should Entity B consolidate the VIE?		
Supporting factors:	**View 1:** Yes	**View 2:** No
a. Purpose and design b. Relationship and significance of the VIE's activities to the related parties	Engine Co. is the sole producer of Car Co.'s engines and a related party to Entity B. Entity B receives majority of benefits through 51% ownership that is its sole investment, and its related party (Car Co.) is the decision maker for Engine Co.	Engine Co. is the sole producer of Car Co.'s engines but sells to other third parties and there are other investors directly in Engine Co.
c. Nature of exposure to VIE	There are no indicators for consolidation.	Benefits are distributed pro rata through equity; therefore, this factor does not support the attribution of decision making authority to Entity B.
d. Magnitude of exposure to VIE's anticipated economic performance	51% is majority.	Although 51% is majority, it is not significantly above majority.

Note: Under the proposal, Car Co. would not consolidate Engine Co. (VIE) because it does not directly or indirectly have power and benefits.