



EXPOSURE DRAFT

Proposed Accounting Standards Update

Issued: August 22, 2013
Comments Due: October 14, 2013

Consolidation (Topic 810)

Applying Variable Interest Entity Guidance to Common
Control Leasing Arrangements

a proposal of the Private Company Council

This Exposure Draft of a proposed Accounting Standards Update of Topic 810 is issued by the Board for public comment. Comments can be provided using the electronic feedback form available on the FASB website. Written comments should be addressed to:

Technical Director
File Reference No. PCC-13-02

Financial Accounting Standards Board
of the Financial Accounting Foundation

The *FASB Accounting Standards Codification*[®] is the source of authoritative generally accepted accounting principles (GAAP) recognized by the FASB to be applied by nongovernmental entities. An Accounting Standards Update is not authoritative; rather, it is a document that communicates how the Accounting Standards Codification is being amended. It also provides other information to help a user of GAAP understand how and why GAAP is changing and when the changes will be effective.

Notice to Recipients of This Exposure Draft of a Proposed Accounting Standards Update

The Board invites comments on all matters in this Exposure Draft and is requesting comments by October 14, 2013. Interested parties may submit comments in one of three ways:

- Using the electronic feedback form available on the FASB website at [Exposure Documents Open for Comment](#)
- Emailing a written letter to director@fasb.org, File Reference No. PCC-13-02
- Sending written comments to “Technical Director, File Reference No. PCC-13-02, FASB, 401 Merritt 7, PO Box 5116, Norwalk, CT 06856-5116.”

Do not send responses by fax.

All comments received are part of the FASB’s public file. The FASB will make all comments publicly available by posting them to the online public reference room portion of its website.

An electronic copy of this Exposure Draft is available on the FASB’s website.

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of the Financial Accounting Foundation
401 Merritt 7, PO Box 5116, Norwalk, Connecticut 06856-5116

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Summary and Questions for Respondents

Why Is the FASB Issuing This Proposed Accounting Standards Update (Update)?

The Private Company Council (PCC) added this issue to its agenda in response to feedback from private company stakeholders indicating that the benefits of applying variable interest entity (VIE) guidance to assess a lessor entity under common control for consolidation in a leasing arrangement do not justify the related costs. Private company stakeholders state, generally, that the primary purpose of establishing a separate lessor entity is for tax and estate-planning purposes—not to structure off-balance-sheet debt arrangements. In instances in which a lessor entity is consolidated by the lessee entity on the basis of VIE guidance, most users of private company financial statements stated that consolidation is not relevant to them because they focus on the cash flows and tangible worth of the standalone reporting lessee entity, as opposed to the consolidated cash flows and tangible worth of the reporting entity as presented under U.S. generally accepted accounting principles (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.

After deliberations, the PCC reached a decision to provide an elective accounting alternative for private companies in applying VIE guidance to lessor entities under common control and the Board endorsed the decision of the PCC to amend the Codification, leading to the issuance of this proposed Update.

Who Would Be Affected by the Amendments in This Proposed Update?

The proposed amendments under the heading “Accounting Alternative” would apply to all entities other than a public business entity, a not-for-profit entity, or an employee benefit plan within the scope of Topics 960 through 965 on plan accounting.

As part of this proposed Update, the Board is proposing the removal of implementation guidance codified from FASB Staff Position No. FIN 46(R)-5, *Implicit Variable Interests under FASB Interpretation No. 46* (revised December 2003). The removal of the example in paragraphs 810-10-55-87 through 55-89 would apply to all entities within the scope of Topic 810.

What Are the Main Provisions?

The proposed amendments would permit a private company to elect not to apply VIE guidance for assessing whether it should consolidate a lessor entity when (1) the lessor entity and the private company are under common control, (2) the private company has a leasing arrangement with the lessor entity, and (3) substantially all of the activity between the two entities is related to the leasing activity of the lessor entity.

The accounting alternative, when elected, would be an accounting policy election that would be applied by a private company to all current and future lessor entities under common control that meet the criteria for applying this approach.

If a private company lessee elects to apply the guidance in this proposed Update, it would be required to disclose additional information about each applicable lessor entity. Such disclosures would include the key terms of the leasing arrangements, the amount of debt and/or significant liabilities of the lessor entity under common control, the key terms of existing debt agreements of the lessor entity under common control, and the key terms of any other explicit interest related to the lessor entity under common control. In addition, entities that elect this alternative should continue to apply other applicable Codification guidance, including Topic 840, Leases, and Topic 460, Guarantees.

How Would the Main Provisions Differ from Current U.S. Generally Accepted Accounting Principles (GAAP) and Why Would They Improve U.S. GAAP for Private Company Stakeholders?

Currently, U.S. GAAP requires a reporting entity to consolidate an entity in which it has a controlling financial interest. There are two primary models for assessing whether there is a controlling financial interest: the voting interest model and the variable interest entity model (VIE model). Under the voting interest model, the principle for a controlling financial interest is contractual or other legal arrangements that provide ownership of a majority voting interest. Under the VIE model, a reporting entity is deemed to have a controlling financial interest (primary beneficiary) when it has both (1) the power to direct the activities that most significantly affect the economic performance of the entity and (2) 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 reporting entity must first determine whether it has a variable interest in a VIE.

Under the amendments in this proposed Update, a private company could elect, when certain conditions exist, not to apply VIE guidance for assessing whether it should consolidate lessor entities under common control.

The PCC believes that the proposed accounting alternative, when elected, would improve financial reporting for the users of private company financial statements while reducing the cost and complexity associated with applying VIE guidance to leasing arrangements under common control. Most users of private company financial statements state that the consolidation of lessor entities under common control distorts the financial statements of lessee entities. The PCC also believes that for those users who find relevance in lessee entities consolidating lessor entities under common control, the proposed disclosures under this alternative would provide the necessary information without the cost and complexity of applying VIE guidance.

The PCC believes that the accounting alternative for applying VIE guidance to common control leasing arrangements is responsive to the unique needs of private companies and that it would 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 VIE guidance. Therefore, the PCC believes that the proposed amendments meet the overall objective of the draft Private Company Decision-Making Framework for addressing the unique needs of private company stakeholders.

When Would the Amendments Be Effective?

The accounting alternative, when elected, would be applied retrospectively. The effective date will be determined after the PCC considers stakeholder feedback on this proposed Update.

Questions for Respondents

The Board and the PCC invite individuals and organizations to comment on all matters in this proposed Update, particularly on the issues and questions below. While certain questions are addressed to specific types of stakeholders, respondents are welcome to respond to any of the questions. Comments are requested from those who agree with the proposed guidance as well as from those who do not agree. Comments are most helpful if they identify and clearly explain the issue or question to which they relate. Those who disagree with the proposed guidance are asked to describe their suggested alternatives, supported by specific reasoning.

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

- a. Please indicate whether you primarily are a preparer, user, or public accountant. 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 the 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, surety, analyst, or rating agency) and whether you primarily use financial statements of private entities or those of both private entities and public entities.

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?

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.

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

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.

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?

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.

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?

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?

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?

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

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.

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?

Amendments to the *FASB Accounting Standards Codification*[®]

Introduction

1. The Accounting Standards Codification is amended as described in paragraphs 2–8. In some cases, to put the change in context, not only are the amended paragraphs shown but also the preceding and following paragraphs. Terms from the Master Glossary are in **bold** type. Added text is underlined, and deleted text is ~~struck out~~.

Amendments to Master Glossary

2. Add the following new Master Glossary terms, with a link to transition paragraph 810-10-65-4, as follows:

Private Company

An entity other than a **public business entity**, a **not-for-profit entity**, or an employee benefit plan within the scope of Topics 960 through 965 on plan accounting.

Public Business Entity

A business entity meeting any one of the following criteria would be considered public:

- 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, 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, as amended, or rules or regulations promulgated under the Act, to file or furnish financial statements with a regulatory agency.
- c. It is required to file or furnish financial statements with a regulatory agency in preparation for the sale of securities or for purposes of issuing securities.
- d. It has (or is a conduit bond obligor for) unrestricted securities that are traded or can be traded on an exchange or an over-the-counter market.
- e. Its securities are unrestricted, and it is required to provide U.S. GAAP financial statements to be made publicly available on a periodic basis pursuant to a legal or regulatory requirement.

This excludes a not-for-profit entity or an employee benefit plan within the scope of Topics 960 through 965 on plan accounting.

Amendments to Subtopic 810-10

3. Add paragraphs 810-10-15-17A through 15-17B and their related heading, with a link to transition paragraph 810-10-65-4, as follows:

Consolidation—Overall

Scope and Scope Exceptions

Variable Interest Entities

> Accounting Alternative

810-10-15-17A A legal entity need not be evaluated by a private company to determine whether the legal entity shall be subject to consolidation under the guidance in the Variable Interest Entities Subsections if all of the following criteria are met:

- a. The private company and the legal entity are under common control.
- b. The private company has a lease arrangement with the legal entity.
- c. Substantially all activities between the private company and the legal entity are related to the leasing activities (including supporting leasing activities) of the legal entity.

Implementation guidance on what constitutes supporting leasing activities is provided in paragraph 810-10-55-9.

810-10-15-17B Application of this accounting alternative is an accounting policy election that shall be applied by a private company to all legal entities, provided that all of the criteria for applying this accounting alternative specified in the preceding paragraph are met. For legal entities that are excluded from being evaluated under the guidance in the Variable Interest Entities Subsections as a result of this accounting alternative, a private company shall continue to apply other Topics as applicable. A private company that elects this accounting alternative shall disclose the required information specified in paragraph 810-10-50-2AD.

4. Supersede paragraph 810-10-25-48 and amend paragraphs 810-10-25-52 and 810-10-25-54, with a link to transition paragraph 810-10-65-4, as follows:

Recognition

Variable Interest Entities

> > Implicit Variable Interests

~~**810-10-25-48** Paragraph superseded by Accounting Standards Update 2013-XX. Implicit variable interests commonly arise in leasing arrangements among related parties, and in other types of arrangements involving related parties and unrelated parties.~~

810-10-25-52 The identification of explicit variable interests involves determining which contractual, ownership, or other pecuniary interests in a legal entity directly absorb or receive the variability of the legal entity. An implicit variable interest acts the same as an explicit variable interest except it involves the absorbing and (or) receiving of variability indirectly from the legal entity, rather than directly from the legal entity. Therefore, the identification of an implicit variable interest involves determining whether a reporting entity may be indirectly absorbing or receiving the variability of the legal entity. The determination of whether an implicit variable interest exists is a matter of judgment that depends on the relevant facts and circumstances. For example, an implicit variable interest may exist if the reporting entity can be required to protect a variable interest holder in a legal entity from absorbing losses incurred by the legal entity. See ~~Example 4 (paragraph 810-10-55-87)~~ for an illustration of this guidance.

810-10-25-54 The reporting entity shall consider whether it holds an implicit variable interest in the VIE or potential VIE. The determination of whether an implicit variable interest exists shall be based on all facts and circumstances in determining whether the reporting entity may absorb variability of the VIE or potential VIE. 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. The guidance in paragraphs ~~810-10-25-48~~810-10-25-49 through 25-54 applies to related parties as defined in paragraph 810-10-25-43. For example, the guidance in paragraphs ~~810-10-25-48~~810-10-25-49 through 25-54 applies to any of the following situations:

- a. A reporting entity and a VIE are under common control.
- b. A reporting entity has an interest in, or other involvement with, a VIE and an officer of that reporting entity has a variable interest in the same VIE.

- c. A reporting entity enters into a contractual arrangement with an unrelated third party that has a variable interest in a VIE and that arrangement establishes a related party relationship.

5. Add paragraph 810-10-50-2AD and its related heading and amend paragraph 810-10-50-5A, with a link to transition paragraph 810-10-65-4, as follows:

Disclosure

Variable Interest Entities

> Accounting Alternative

810-10-50-2AD A private company that does not apply the requirements of the Variable Interest Entities Subsections to one or more legal entities because the criteria in paragraph 810-10-15-17A are met, shall disclose all of the following information:

- 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.

> Primary Beneficiaries or Other Holders of Interests in VIEs

810-10-50-5A A reporting entity that is a primary beneficiary of a VIE or a reporting entity that holds a variable interest in a VIE but is not the entity's primary beneficiary shall disclose all of the following:

- a. Its methodology for determining whether the reporting entity is the primary beneficiary of a VIE, including, but not limited to, significant judgments and assumptions made. One way to meet this disclosure requirement would be to provide information about the types of involvements a reporting entity considers significant, supplemented with information about how the significant involvements were considered in determining whether the reporting entity is the primary beneficiary.
- b. If facts and circumstances change such that the conclusion to consolidate a VIE has changed in the most recent financial statements

(for example, the VIE was previously consolidated and is not currently consolidated), the primary factors that caused the change and the effect on the reporting entity's financial statements.

- c. Whether the reporting entity has provided financial or other support (explicitly or implicitly) during the periods presented to the VIE that it was not previously contractually required to provide or whether the reporting entity intends to provide that support, including both of the following:
 1. The type and amount of support, including situations in which the reporting entity assisted the VIE in obtaining another type of support
 2. The primary reasons for providing the support.
- d. Qualitative and quantitative information about the reporting entity's involvement (giving consideration to both explicit arrangements and implicit variable interests) with the VIE, including, but not limited to, the nature, purpose, size, and activities of the VIE, including how the VIE is financed. Paragraphs ~~810-10-25-48~~810-10-25-49 through 25-54 and ~~Example 4 (see paragraph 810-10-55-87)~~ provide guidance on how to determine whether a reporting entity has an implicit variable interest in a VIE.

6. Add paragraph 810-10-55-9 and its related heading and supersede paragraphs 810-10-55-87 through 55-89 and their related heading, with a link to transition paragraph 810-10-65-4, as follows:

Implementation Guidance and Illustrations

Variable Interest Entities

> Implementation Guidance

> > Accounting Alternative

~~810-10-55-9 Paragraph not used.~~ In applying the guidance in paragraph 810-10-15-17A, a guarantee provided by a **private company** to the lender of a legal entity under common control for a mortgage on the legal entity's assets used for leasing is considered to be related to the leasing activity (of the legal entity) even though the guarantee may be in excess of the lease payments that the private company is required to make under its leasing arrangement with the legal entity. A joint and several liability arrangement for a mortgage on the legal entity's assets used for leasing also is considered to be related to the leasing activity. Other arrangements unrelated to guarantees or joint and several arrangements relating to the mortgage on the legal entity's assets, such as a purchase

commitment of products with the legal entity, are not considered to be related to the leasing activity of the legal entity.

>> Example 4: Implicit Variable Interests

~~810-10-55-87 Paragraph superseded by Accounting Standards Update 2013-XX. This Example illustrates the guidance in paragraphs 810-10-25-48 through 25-54.~~

~~810-10-55-88 Paragraph superseded by Accounting Standards Update 2013-XX. 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 Paragraph superseded by Accounting Standards Update 2013-XX. 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.~~

7. Add paragraph 810-10-65-4 and its related heading as follows:

**> Transition Related to Accounting Standards Update No. 2013-XX,
Consolidation (Topic 810): Applying Variable Interest Entity Guidance to
Common Control Leasing Arrangements**

810-10-65-4 The following represents the transition and effective date information related to Accounting Standards Update No. 2013-XX, *Consolidation (Topic 810): Applying Variable Interest Entity Guidance to Common Control Leasing Arrangements*:

- a. The pending content that links to this paragraph shall be effective for fiscal years beginning after [date to be inserted after exposure], and interim and annual periods after that date.
- b. The pending content that links to this paragraph shall be applied retrospectively to financial statements for each individual prior period presented. Those financial statements would be adjusted to reflect the period-specific effects of applying the accounting alternative.
- c. If a reporting entity deconsolidates a VIE as a result of the application of the pending content that links to this paragraph, the deconsolidating reporting entity shall initially measure any retained interest in the deconsolidated subsidiary at its carrying amount at the date the pending content that links to this paragraph is first applied. In this context, *carrying amount* refers to the amount at which any retained interest would have been carried in the reporting entity's financial statements if the pending content that links to this paragraph had been effective when the reporting entity became involved with the VIE. Any difference between the net amount removed from the balance sheet of the deconsolidating reporting entity and the amount of any retained interest in the newly deconsolidated VIE shall be recognized as a cumulative-effect adjustment to retained earnings. The amount of any cumulative-effect adjustment related to deconsolidation shall be disclosed separately from any cumulative-effect adjustment related to consolidation of VIEs.

Amendments to Subtopic 840-10

8. Amend paragraph 840-10-60-4, with a link to transition paragraph 810-10-65-4, as follows:

Leases

Relationships

General

> Consolidation

840-10-60-4 For guidance on the identification of implicit variable interests, see the guidance beginning in paragraph ~~810-10-25-48~~810-10-25-49. ~~Example 4 (paragraph 810-10-55-87) illustrates the application of that guidance to a leasing entity that is a variable interest entity.~~

The amendments in this proposed Update were endorsed and approved for publication by the unanimous vote of the six members of the Financial Accounting Standards Board:

Russell G. Golden, *Chairman*
Daryl E. Buck
Thomas J. Linsmeier
R. Harold Schroeder
Marc A. Siegel
Lawrence W. Smith

Background Information and Basis for Conclusions

Introduction

BC1. The following summarizes the PCC's considerations in reaching the conclusions in this proposed Update. It includes the Board's basis for endorsing the PCC's conclusions when needed to supplement the PCC's considerations. It also includes reasons for accepting certain approaches and rejecting others. Individual PCC members and Board members gave greater weight to some factors than to others.

BC2. On February 12, 2013, based on input received through outreach with users, preparers, and public accountants of private company financial statements and based on feedback received in various other forums, the PCC decided to add to its agenda a project that would explore potential alternatives for applying VIE guidance to common control leasing arrangements. On July 16, 2013, the PCC reached a decision to provide an elective accounting alternative for private companies in applying VIE guidance to lessor entities under common control. On August 7, 2013, the Board endorsed the decisions of the PCC to amend the Codification, leading to the issuance of this proposed Update.

BC3. The proposed amendments would permit private companies within the scope of this proposed Update to elect not to apply VIE guidance for assessing whether it should consolidate a lessor entity when (a) the lessor entity and the private company are under common control, (b) the private company has a leasing arrangement with the lessor entity, and (c) substantially all of the activity between the two entities is related to the leasing activity of the lessor entity.

Scope

BC4. The PCC decided the scope of this proposed Update should be consistent with the scope of the draft Private Company Decision-Making Framework (Guide). The scope of the draft Guide will be set by a separate but concurrent project, Definition of a Public Business Entity, which is currently being exposed for public comment by the Board. Therefore, the proposed amendments would apply to all entities other than a public business entity, a not-for-profit entity, or an employee benefit plan within the scope of Topics 960 through 965 on plan accounting.

BC5. The Board believes that the proposed Update should not apply to public business entities and employee benefit plans because they lack the

arrangements that this accounting alternative addresses. On the basis of the feedback it receives through the comments on the proposed Update and through outreach, the Board will consider whether the scope of the accounting alternative should be expanded to include public business entities or employee benefit plans. Not-for-profit entities already are substantially excluded from the scope of VIE guidance.

BC6. The PCC decided that the proposed accounting alternative, when elected, would be an accounting policy election that would be applied by a private company to all current and future lessor entities under common control that meet the criteria for applying this approach.

Background Information

BC7. Currently, U.S. GAAP requires a reporting entity to consolidate an entity in which it has a controlling financial interest. There are two primary models for assessing whether there is a controlling financial interest: the voting interest model and the variable interest entity model (VIE model). Under the voting interest model, the principle for a controlling financial interest is contractual or other legal arrangements that provide ownership of a majority voting interest. Under the VIE model, a reporting entity is deemed to have a controlling financial interest (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 reporting entity must first determine whether it has a variable interest in a VIE.

BC8. Currently, Topic 810 codifies an example derived from FSP FIN 46(R)-5 in paragraphs 810-10-55-87 through 55-89 (FSP example). In the FSP example, a reporting entity (lessee entity) leases a facility from a leasing entity (lessor entity) that is owned by one of the reporting entity's two owners and has the facility as its only asset. The operating lease, with market terms, is the only contractual relationship between the two entities. 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 entity in such circumstances to consider whether it holds an implicit variable interest, for example, a guarantee of the lessor's debt. If a lessee entity holds a variable interest (explicit or implicit) in the lessor entity and determines that the lessor entity is a VIE, then the lessee entity must assess whether it holds a controlling financial interest in the lessor entity. As a result, a lessee entity, in certain circumstances, may be required under existing U.S. GAAP to consolidate a lessor entity when they are both under common control.

BC9. The PCC added this issue to its agenda in response to feedback from private company stakeholders through various channels including (a) the nonpublic entity roundtables, (b) written submissions to the Blue-Ribbon Panel

on Standard Setting for Private Companies and the Financial Accounting Foundation's Plan to Establish the Private Company Standards Improvement Council, and (c) the Private Company Financial Reporting Committee. Many private company stakeholders indicated that consolidation should be a high hurdle. In other words, unless it is clearly evident that an entity's rights provide the entity with the ability to control another entity, users of private company financial statements typically do not support consolidation. Most private company stakeholders state that VIE guidance is unduly complex and costly to apply. Furthermore, many private company stakeholders state that VIE guidance is difficult to follow and is fragmented.

BC10. While the feedback on VIE guidance was broad, one area that most private company stakeholders focused on was applying VIE guidance to lessor entities under common control with the reporting lessee entity. The most typical example cited is one that mirrors the FSP example discussed in paragraph BC8 or is some variation of the FSP example. Private company stakeholders state, generally, that the primary purpose of establishing a separate lessor entity is for tax and estate-planning purposes—not to structure off-balance-sheet debt arrangements. In instances in which a lessor entity is consolidated by the lessee entity on the basis of VIE guidance, most users of private company financial statements stated that consolidation is not relevant to them because they focus on the cash flows and tangible worth of the standalone reporting lessee entity, as opposed to the consolidated cash flows and tangible worth of the reporting entity as presented under U.S. 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.

BC11. Some users of private company financial statements, such as sureties, stated that consolidation of lessor entities under common control provides decision-useful information. However, sureties have expressed the most interest in knowing about the terms of the borrowing entered into by the lessor; this is especially true when the performance of a bonded project relies on collateralized equipment or property held by the lessor. Some sureties also have stated that robust disclosures about the terms of the borrowings of the lessor could be sufficient in instances in which the lessor entity is not consolidated.

Alternative to Applying VIE Guidance to Leasing Arrangements under Common Control

BC12. On the basis of input from private company stakeholders, the PCC proposed amendments to introduce an alternative that addresses the concerns about applying VIE guidance to leasing arrangements under common control. The PCC believes that the alternative method, if elected, would reduce the cost and complexity of preparing financial statements while continuing to provide

decision-useful information to users of private company financial statements. For those users who find relevance in lessee entities consolidating lessor entities under common control, the PCC believes that the proposed disclosures under this alternative would provide the necessary information without the cost and complexity of applying VIE guidance.

BC13. In deliberating the proposed alternative, the PCC initially considered a criterion that would require substantially all of the lessor entity's activities to consist of leasing or the support of leasing. Under such a criterion, a business activity unrelated to the lessee entity would have precluded the use of this proposed alternative. During deliberations, the PCC considered that a greater level of activity by the lessor entity unrelated to the lessee entity would decrease the likelihood of consolidation under the VIE model. Therefore, the PCC decided that the criterion should be changed so that substantially all of the activity between the lessee entity and the lessor entity must be related to leasing. That decision would allow an entity not to perform a comprehensive VIE analysis of situations that likely would result in no consolidation.

BC14. In determining what activities are related to leasing, the PCC decided that a guarantee by the lessee entity on the lessor entity's mortgage on a leased asset would qualify as a leasing activity. The PCC concluded that such a guarantee is related to the lease even when the guarantee may be in excess of the lease payments that the lessee entity is required to make under its leasing arrangement with the lessor entity. The PCC also believes that an implicit guarantee on the lessor entity's mortgage should not require a VIE assessment, and the PCC did not view an explicit guarantee any differently. Some PCC members considered restricting guarantees on a mortgage on a leased asset to the lease payments because they believe that guarantees of amounts greater than the lease payments could be indicative of arrangements that should be considered for consolidation under VIE guidance. The PCC believes that such a restriction would be difficult to apply. Furthermore, the PCC decided that the disclosures resulting from the proposed alternative, including those required by other Topics, would mitigate the concerns of having a less restrictive requirement to qualify for the proposed accounting alternative.

BC15. The PCC considered two other alternatives for addressing the concerns of applying VIE guidance to leasing arrangements under common control. The first alternative was to provide more guidance on the identification of variable interest (variable interest alternative). The variable interest alternative would have modified the FSP example in the implementation guidance discussed in paragraph BC8 by clarifying that a variable interest, such as an implied guarantee on the lessor entity's debt, does not exist. The basis for such a conclusion is that a variable interest should absorb variability that is created by a legal entity and passed along to its interest holders. The modified example would have stressed that the implied guarantee would not be considered to be a variable interest because an implied guarantee on the lessor entity's debt primarily absorbs the risk created by the lessee entity itself not making its

required lease payments and, therefore, does not represent variability that is created by the legal entity and is passed through to the interest of the lessee entity.

BC16. The PCC decided against the variable interest alternative because that alternative does not address explicit variable interests. The PCC was concerned that explicit interests related to leasing arrangements under common control could still result in consolidation under VIE guidance. Some members of the PCC also were concerned with the possibility of unintended consequences as a result of modifying implicit variable interest guidance. Furthermore, the PCC believes that the variable interest alternative, as compared with current U.S. GAAP, would still be costly and complex for private companies in applying VIE guidance to leasing arrangements under common control. However, these cost concerns may be overstated given that the variable interest alternative would focus on the first step of the VIE model by making it clear, in most circumstances addressed by this proposed Update, that the lessee would not have a variable interest in the lessor and, therefore, would not need to apply the VIE model.

BC17. Another alternative considered by the PCC was to clarify the primary beneficiary assessment by leveraging the example discussed in paragraph BC8 and adding implementation guidance on how to identify the primary beneficiary (primary beneficiary alternative). That implementation guidance would have provided a detailed example in which a lessee entity would not have the power to direct the activities that most significantly affect a lessor entity under common control and, as a result, would not require consolidation of the lessor entity.

BC18. The PCC decided against the primary beneficiary alternative because it focuses on the last step of the VIE model. The PCC believes that this alternative would not address the cost and complexity of applying VIE guidance to leasing arrangements under common control.

Removal of the FSP Example

BC19. Based on the recommendation of the PCC, the Board decided to eliminate the FSP example that is codified in paragraphs 810-10-55-88 through 55-89. The Board and the PCC believe that the accounting alternative in this proposed Update contradicts the FSP example because it exempts private companies with a fact pattern very similar to the FSP example from applying VIE guidance. In addition, some stakeholders stated that the FSP example does not result in the lessee entity holding an implicit variable interest in the form of a guarantee on the lessor entity's debt. Those stakeholders agree with the basis that supports the alternative discussed in paragraph BC15.

BC20. Although the removal of the FSP example would affect private companies and both public business entities and employee benefit plans, the Board believes that the FSP example primarily applies to private companies and that its removal will not have a significant effect on public business entity and employee benefit plan stakeholders. The Board also did not consider the effect of

removal of the FSP example on not-for-profit entities because not-for-profit entities already are substantially excluded from the scope of VIE guidance.

Disclosure

BC21. To the extent a lessor is not consolidated, Topic 840 already requires a private company lessee to disclose current-period rent expense charged by the lessor entity under common control and future committed lease payments based on a lease agreement. In addition, the lessee entity would be required to provide other applicable disclosures in U.S. GAAP, including those required by Topic 460, Guarantees.

BC22. The PCC decided that a private company lessee that elects to apply the accounting alternative also would have to provide additional disclosures about each applicable lessor entity as a result of applying the accounting alternative. Those additional disclosures include the key terms of the leasing arrangements, the amount of debt and/or significant liabilities of the lessor entity under common control, key terms of debt agreements of the lessor entity under common control, and the key terms of any other explicit interest related to the lessor entity under common control.

BC23. While most users of private company financial statements stated that consolidation of lessor entities under common control does not provide decision-useful information, the PCC recognizes that some users, such as sureties, disagree. The PCC believes that the disclosures in the aggregate about the nonconsolidated lessor entity would accommodate the information needs of sureties.

BC24. The PCC also considered access to management in developing an alternative to address the concerns of applying VIE guidance to lessor entities under common control. The PCC believes that this proposed Update provides sufficient quantitative and qualitative disclosure in the notes necessary to facilitate a user's review and to allow a user to identify appropriate follow-up questions to management when the user deems it necessary to do so (the red-flag approach to disclosure).

Transition

BC25. The PCC decided that a private company would apply the alternative, when elected, 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. The PCC believes that the benefit of consistent consolidated financial information between reporting periods outweighs the cost and complexity of applying a full retrospective approach.

BC26. The PCC does not believe that full retrospective application of the amendments in this proposed Update would be burdensome or costly. Feedback

from users indicated that they often request consolidating schedules when a lessee entity consolidates a lessor entity. Those schedules could be used by preparers to apply the amendments in this proposed Update retrospectively.

Effect on Relevance and Cost under the Private Company Decision-Making Framework

BC27. The objective of financial reporting is to provide information that is useful to present and potential investors, creditors, and other capital market participants in making rational investment, credit, and similar resource allocation decisions. However, the benefits of providing information for that purpose should justify the related costs. The draft Guide augments the existing conceptual framework for financial reporting to provide additional considerations in making user-relevant and cost-benefit evaluations for private companies. The draft Guide is a tool to help the Board and the PCC identify differential information needs of users of public company financial statements and users of private company financial statements, and/or to identify opportunities to reduce the cost and complexity of preparing financial statements in accordance with U.S. GAAP. The PCC's assessment of the costs and benefits of issuing new guidance is unavoidably more qualitative than quantitative because there is no method to objectively measure the costs to implement new guidance or to quantify the value of improved information in financial statements.

BC28. The PCC believes that the proposed accounting alternative, when elected, would improve or maintain financial reporting for the users of private company financial statements while reducing the cost and complexity associated with applying VIE guidance to leasing arrangements under common control. Most users of private company financial statements state that the consolidation of lessor entities under common control distorts the financial statements of lessee entities. For those users who find relevance in consolidating lessor entities under common control, the PCC believes that the proposed disclosures under this proposed accounting alternative would provide the necessary information without the cost and complexity of applying VIE guidance.

BC29. The PCC believes that the accounting alternative for applying VIE guidance to common control leasing arrangements is responsive to the unique needs of private companies and that it would 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 VIE guidance. Therefore, the PCC believes that the proposed amendments meet the overall objective of the draft Guide for addressing the unique needs of private company stakeholders.