

Memo No. **1**

**Memo**

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Project	<b>Consolidations: Targeted Improvements</b>
Project Stage	<b>Research Agenda</b>
Issue(s)	<b>Common Control Arrangements</b>

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**Purpose of This Memo**

1. The purpose of this memorandum is to seek the PCC's feedback on the Board's research project on Consolidations. More specifically, the memorandum will seek feedback on:
  - a. Alternatives to address private company issues related to applying Variable Interest Entity (VIE) guidance to private companies under common control;
  - b. The research project on potentially simplifying the guidance in Topic 810; and
  - c. Considerations for addressing related-party guidance specific to VIEs in Topic 810 for entities under common control.
2. This memo is organized as follows:
  - a. General Background on the Research Project
  - b. Applying VIE Guidance to Private Companies Under Common Control
    - (i) Overview
    - (ii) Background and History

- (iii) Alternatives
  - (iv) Summary of Outreach on Alternative 1
  - (v) Staff Recommendation – Analysis under the Private Company Decision Making Framework
- c. Simplification and Reorganization
  - d. Common Control Related-Party Guidance for Public Business Entities

### **General Background on the Research Project**

- 3. In December 2015, the PCC decided to add a project to its agenda to clarify how to apply the guidance for VIEs in Topic 810, Consolidation, to private companies under common control. In February 2016, the Board added a research project to the FASB agenda to consider simplifying the guidance in Topic 810 by (a) reorganizing the guidance to make it easier to understand and apply and/or (b) simplifying complex areas (for example, terms and concepts) to make them easier to apply in practice. In April 2016, the PCC recommended that its project on applying VIE guidance to private companies under common control be added to the Board’s agenda to address VIE guidance more holistically. Finally, the Board recently asked the staff to consider whether related-party guidance within the related-party fees paid to decision makers sections of the VIE guidance in Topic 810 (for determining whether the fees are variable interests) specific to common control arrangements could be amended to simplify the application of this guidance.

### **Applying VIE Guidance to Private Companies Under Common Control**

- 4. Since December 2015, the staff has identified and considered (through research, outreach, and analysis) the following three alternatives for addressing the difficulties reported when applying VIE guidance to private companies under common control:

**Alternative 1:** *Draft Examples to Clarify the Application of Existing VIE Guidance*

The original request from the PCC and the first alternative the staff considered.

**Alternative 2:** *New Model for Consolidation of Private Companies under Common Control*

Longer-term project to create a common control model that would apply to both public and private companies.

**Alternative 3:** *A Scope Exception for Applying VIE Guidance for Private Companies under Common Control*

Private company alternative that would provide a scope exception for applying the VIE guidance in Topic 810, including the determination of whether a private company under common control is a VIE

5. Each of these alternatives were developed after outreach and discussion with the PCC and certain FASB staff members. The staff also provided a significant amount of analysis to determine which alternative would both (a) simplify the consolidation guidance for private companies under common control so that the guidance could be applied consistently and be decision-useful, and (b) have minimal to no effect on public companies.

**Background and History**

6. This project resulted from several PCC members who asserted that the VIE guidance within Topic 810 is overly complex and difficult to apply, particularly to private companies under common control. The staff was directed by the PCC to conduct research on these concerns and to identify viable alternatives to address them in the middle of 2015. For a summary of the requirements in the VIE guidance, refer to Appendix A. PCC members were concerned that the VIE guidance is currently so complex that it results in diversity in application and could result in consolidation conclusions that may not be decision-useful to users of private company financial statements.
7. As a result of its outreach, the staff confirmed that diversity in the application of consolidation guidance for common control arrangements was pervasive. The staff learned that inconsistent application was most common in local, regional, and midsized firms (because preparers generally rely on accounting firms for consolidation guidance). The

staff also learned that users, regardless of the guidance in Topic 810, wanted consolidation in certain circumstances but not others. This was based on the staff's original outreach to users in which only two alternatives were provided; consolidation or no consolidation. For additional information about the outreach previously performed, refer to Appendix B.

8. After the staff presented the outreach findings to the PCC, the staff was directed at the December 2015 PCC meeting to draft examples for potential inclusion in the Codification that would help illustrate the application of VIE guidance to private companies under common control. At the April PCC meeting, the staff shared its research with the PCC, which included drafted examples to analyze scenarios and help clarify the guidance. These examples had been discussed with the PCC VIE working group and Board members but the results were inconclusive, as the application of the examples did not result in a consensus of views among PCC VIE working group members or Board members. Therefore, the discussion at the April PCC meeting was whether the examples would be helpful to private company stakeholders overall in clarifying the guidance.
9. After discussion at the April PCC meeting, the PCC voted to recommend that this project be moved to the Board's agenda to address VIE concerns more broadly. The Board added a project to its research agenda to address consolidation of private companies under common control with the goal of determining whether a solution could be developed for consistent application of the guidance for both public and private companies. Recently, the staff performed additional outreach that was more extensive and provided disclosure alternatives that the staff thought would make it possible for users to understand the transactions, risks, and other pertinent transactions between private companies under common control (on the basis of related party and VIE disclosures).

### *Alternatives*

10. After the staff and PCC established that the original plan to provide illustrative guidance to clarify the application of VIE guidance was not a viable path to address the identified concerns, the staff began researching other alternatives. The two alternatives the staff would like the PCC to consider are:

**Alternative 1:** Create a scope exception that exempts private companies under common control from having to apply the VIE guidance in Topic 810 (they still would be required to consider other consolidation guidance within the Topic)

**Alternative 2:** Create a new model for common control arrangements for both public and private company common control arrangements that are, or could be, VIEs.

The following discussion analyzes each alternative to determine which is the most effective for promoting consistency in application for private companies without causing inconsistency in public company conclusions.

*Alternative 1 – Scope Exception from VIE Guidance in Topic 810 for Private Companies*

11. Under Alternative 1, the staff considered whether to create a scope exception that would exempt private companies under common control from applying the VIE guidance in Topic 810, including the guidance for determining whether an entity is a VIE. The overriding principle of Alternative 1 is that the parent company of the entities under common control would inherently always consolidate the private companies under common control.
12. The common control company providing financial statements would still be required to apply other GAAP (most often the voting interest model) in Topic 810 for consolidation. In other words, if a private company under common control has a controlling financial interest in another private company under common control through equity interests, it may be required to consolidate the other private company. It is also imperative to highlight the fact that entities under common control are allowed to combine their financial statements.
13. The scope exception would apply only to private companies under common control. The parent or individual(s) (the parent) controlling the private companies must also be a private company. The parent cannot control any public companies or the scope exception will not apply.
14. Under this alternative, the guidance on common control lease arrangements issued in 2014 in Accounting Standards Update No. 2014-07, *Consolidation (Topic 810): Applying Variable Interest Entities Guidance to Common Control Leasing Arrangements*, would be

rescinded and these common control transactions would be completely scoped out of the VIE guidance in Topic 810.

*Proposed Scope of Alternative 1*

15. The staff is proposing the following language to define the scope exception described in Alternative 1:

**810-10-15-XXX** A legal entity need not be evaluated by a private company (reporting entity) under the guidance in the Variable Interest Entities Subsections if criteria (a) through (c) are met:

- a. The reporting entity and the legal entity are under common control of a parent or individual(s)
- b. The common parent or individual(s) is a private company
- c. All entities under the control of the common parent or individual(s) are private companies

A reporting entity that as a result of this scope exception is excluded from applying the guidance in the Variable Interest Entities Subsections shall continue to apply other accounting guidance (including guidance in the General Subsections of this Subtopic as applicable). A parent, on a stand-alone basis, and its consolidated subsidiary are not considered under common control for purposes of this scope exception. A reporting entity applying this scope exception shall disclose the required information specified in paragraph 810-10-50-XXX unless the legal entity is consolidated through accounting guidance other than VIE guidance. The common parent or individual(s) shall consolidate the legal entity when, collectively through its commonly controlled interests, it has a controlling financial interest in the legal entity.

16. In identifying the scope for Alternative 1, the staff considered the outreach performed with users and preparers indicating that most private companies under common control do not have explicit or “arm’s-length” contractual arrangements in place unless a third party requires them. The staff believes that the absence of such contractual arrangements or the less formalized nature of private companies confounds the assessment of power under the VIE model. In addition, the staff understands that the common parent in a structure with all private company subsidiaries has control to dictate the nature of relationships, including changing that nature, among its commonly controlled entities very easily. However, the staff generally found the opposite to be true for public companies; that is, decision-making rights and power are generally more formalized. The staff believes that

the difficulty in assessing power under the VIE model for private companies under common control is a major driver of the current diversity in practice. As such, the staff believes that the scope of Alternative 1 should be limited to only arrangements when all entities under consideration are private companies. The staff recognizes that this deviates from the scope originally intended in Accounting Standards Update No. 2013-12, *Definition of a Public Business Entity—An Addition to the Master Glossary*, but the staff believes that such a scope is responsive to the concerns raised by private company stakeholders and would reduce the complexity of applying Alternative 1.

*Proposed Disclosures under Alternative 1*

17. The disclosures would only apply if the private company under common control is not consolidated under the voting interest model or another consolidation model. The parent company that inherently consolidates all of its commonly controlled private companies would not be required to provide those disclosures.
18. Specifically, the primary disclosures that the staff would leverage in writing the alternative are as follows:

**810-10-50-2AA** The principal objectives of this Subsection’s required disclosures are to provide financial statement users with an understanding of all of the following:

- c. The nature of, and changes in, the risks associated with a reporting entity’s involvement with the VIE.
- d. How a reporting entity’s involvement with the VIE affects the reporting entity’s financial position, financial performance, and cash flows.

**810-10-50-4** In addition to disclosures required by other guidance, a reporting entity that holds a variable interest in a VIE, but is not the VIE’s primary beneficiary, shall disclose:

- a. The carrying amounts and classification of the assets and liabilities in the reporting entity’s statement of financial position that relate to the reporting entity’s variable interest in the VIE.
- b. The reporting entity’s maximum exposure to loss as a result of its involvement with the VIE, including how the maximum exposure is determined and the significant sources of the reporting entity’s exposure to the VIE. If the reporting entity’s maximum exposure to loss as a result of its involvement with the VIE cannot be quantified, that fact shall be disclosed.

**850-10-50-1** Financial statements shall include disclosures of material related party transactions, other than compensation arrangements, expense allowances, and other similar items in the ordinary course of business. However, disclosure of transactions that are eliminated in the preparation of consolidated or combined financial statements is not required in those statements. The disclosures shall include:

- a. The nature of the relationship(s) involved
- b. A description of the transactions, including transactions to which no amounts or nominal amounts were ascribed, for each of the periods for which income statements are presented, and such other information deemed necessary to an understanding of the effects of the transactions on the financial statements
- c. The dollar amounts of transactions for each of the periods for which income statements are presented and the effects of any change in the method of establishing the terms from that used in the preceding period
- d. Amounts due from or to related parties as of the date of each balance sheet presented and, if not otherwise apparent, the terms and manner of settlement

**850-10-50-6** If the reporting entity and one or more other entities are under common ownership or management control and the existence of that control could result in operating results or financial position of the reporting entity significantly different from those that would have been obtained if the entities were autonomous, the nature of the control relationship shall be disclosed even though there are no transactions between the entities.

19. The staff would also consider amending the guidance leveraged from paragraph 810-10-50-4 regarding the maximum exposure to loss to also include similar language that was created as part of the private company leasing arrangements alternative. That alternative includes the following guidance:

**810-10-50-2AD** A private company lessee under common control that is exempt from applying the requirements of the Variable Interest Entities Subsections to one or more lessor legal entities because it meets the criteria in paragraph 810-10-15-17AB shall disclose the following:

- a. The amount and key terms of liabilities (for example, debt, environmental liabilities, and asset retirement obligations) recognized by the lessor legal entity that expose the private company lessee to providing financial support to the legal entity. For example, a private company lessee exposed to debt of the legal entity should disclose information such as the amount of debt,

interest rate, maturity, pledged collateral, and guarantees associated with the debt.

- b. A qualitative description of circumstances (for example, certain commitments and contingencies) not recognized in the financial statements of the lessor legal entity that expose the private company lessee to providing financial support to the legal entity.

**810-10-50-2AE** In applying the disclosure guidance in paragraph 810-10-50-2AD, a private company lessee under common control shall consider exposures through implicit guarantees. The determination as to whether an implicit guarantee exists is based on facts and circumstances. Those facts and circumstances include, but are not limited to, whether:

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

- 20. The staff believes that this alternative effectively addresses the issue and that a scope exception for private companies with two or more private companies under common control would result in consistent application by private companies for all such arrangements. Although private companies under common control of a private company, an individual, or individuals would not be required to apply VIE guidance, the private company providing financial statements would still be subject to other consolidation guidance, if applicable. Again, combining financial statements for entities under common control is allowed. These arrangements will also require related party disclosures in Topic 850, Related Party Disclosures, supplemented by specific VIE disclosures in Topic 810.

*Alternative 2 – New Model for Common Control*

- 21. This alternative would result in the development of a new model or amendments to existing guidance. The alternative the staff considered would amend the guidance in Topic 810 for determining whether a commonly controlled entity has a controlling financial interest in another commonly controlled entity (for both public and private companies) that has “the power to direct the activities that most significantly impact a VIE’s economic performance” based on explicit contractual or enforceable rights. Under this alternative, it would have to

be determined whether the commonly controlled entity being considered for consolidation is a VIE.

22. As mentioned in paragraph 16, outreach with users and preparers indicated that most private companies under common control do not have explicit or “arm’s-length” contractual arrangements in place unless a third party requires them. Therefore, except in those cases, changing the guidance to rely on contractual rights would be difficult to apply. Additionally, without documentation of contractual rights, no principle based on contractual rights can be created because it inherently could not be interpreted and applied consistently. Therefore, a principle based on contractual rights would be difficult, if not impossible, to apply and audit.
23. Preparers would still be required to create disclosures based on Topic 850 supplemented by certain existing VIE disclosures in Topic 810 in situations in which consolidation amongst commonly controlled entities is not required.
24. Since relying on explicit contractual arrangements inevitably would result in structuring opportunities for public companies, the staff is concerned that a significant amount of additional research and analysis would be required to further develop this alternative before any formal decisions can be made. The need for additional research would also delay any guidance on the application of Topic 810 for private company common control arrangements.
25. Amending the guidance with something that would rely on the form of the contractual rights over the substance of the arrangement would directly conflict with other areas of the same guidance. Paragraph 810-10-15-13A states that

Any term, transaction, or arrangement shall be disregarded when applying the provisions of the Variable Interest Entities Subsections if the term, transaction, or arrangement does not have a substantive effect on any of the following:

- a. A legal entity’s status as a variable interest entity (VIE)
- b. A reporting entity’s power over a VIE
- c. A reporting entity’s obligation to absorb losses or its right to receive benefits of the legal entity.

This too could have unintended consequences with how the guidance is interpreted and applied, which would require additional research.

26. Furthermore, such an alternative would require private companies under common control to apply VIE guidance when outreach already indicates that this model is not well understood. The staff believes that it is not practical to explore this alternative further because there may not be a satisfactory solution that is operational or achievable within a reasonable period of time.

### *Summary of Outreach on Alternative 1*

27. As part of the research into the viability of Alternative 1, the staff conducted research with users of private company financial statements, including members of the PCC and users who are not members of the PCC. The objective of this outreach was to ask those users, who in the staff's previous outreach preferred consolidation, whether a scope exception for private companies under common control with additional disclosures would give them the information they need and how that information would compare to what they get today through the VIE model.
28. The staff called each PCC member who is a user and each external user in the research group individually and walked them through a slide deck that is included in Appendix C of this memo. The slide deck includes background information on the research performed since the November 2015 outreach effort and an example of a basic common control scenario typical to private companies. The staff explained that the scope exception would alleviate the need for private companies to apply the VIE guidance in Topic 810 to private companies under common control. This would result in no consolidation by the commonly controlled legal entity; however, the parent would still consolidate when collectively it has a controlling financial interest in the legal entity. However, additional disclosure based on the required related party disclosures and VIE disclosures would be required. For the external users, the staff also prepared an example of what the disclosures could possibly look like for private companies that apply Alternative 1, which is included in Appendix D.

29. Those users generally supported this alternative and acknowledged that the diversity in practice with how the VIE model is applied makes comparing companies difficult. Under a scope exception, users felt that they would get more consistency while still getting most of the information that they use in the form of additional disclosures. Some users said that they still preferred consolidation, but that the scope exception as described above would be an acceptable alternative. Some users also said that the disclosure is better than consolidation because consolidation decisions are inconsistent and can sometimes obscure the transactions between the entities.

*Staff Recommendation – Analysis under the Private Company Decision-Making Framework*

30. The staff recommends Alternative 1. In developing its recommendation for Alternative 1 (Scope Exception), the staff considered paragraph 1.2 of the Private Company Decision-Making Framework, which states:

the Board and the PCC first should determine whether the recognition or measurement guidance being evaluated provides relevant information to users of private company financial statements at a reasonable cost.

Paragraph 1.4 states that alternative recognition and measurement alternatives should not be considered until the FASB and PCC conclude that either

(a) the information provided by the guidance [under consideration] is not relevant or (b) the information provided by the guidance is relevant but is overly costly or complex to provide and no practical expedient is available....

31. The staff's previous outreach indicated that users of private company financial statements prefer consistent application of accounting guidance and consolidation of brother-sister companies under certain circumstances. Practitioners, preparers, and users all agree that there is significant diversity in practice when it comes to applying VIE guidance to private companies under common control.
32. To address the diversity in practice the staff first attempted to identify potential amendments to improve the consistency of applying VIE guidance. However, the staff believes that this is an intractable task because the assessment of power is critical under the VIE model. Paragraph 16 highlights a unique difference between public and private

companies—that is, most private companies under common control do not have explicit or “arms-length” contractual arrangements in place unless a third party requires them. The lack of contractual arrangements unduly complicates the assessment of power under the VIE model.

33. After exhaustive attempts to identify potential amendments to VIE guidance, the staff believes that a scope exception for private companies under common control is the best path forward. Users of private company financial statements support the disclosures proposed under Alternative 1 and stated that a scope exception will likely promote consistency. Practitioners and preparers have also stated that a scope exception is much easier to apply than VIE guidance. For those reasons, the staff believes that a scope exception meets the overall objective of the Private Company Decision-Making Framework for addressing the needs of private company stakeholders. In other words, Alternative 1 could improve decision-useful information for the users of private company financial statements while reducing the cost and complexity associated with applying VIE guidance to private companies under common control.
34. In addition to recommending a scope exception for private companies, the staff also discusses in this memorandum potential changes for public companies that should result in generally consistent outcomes for the parent company and recognizes that consolidation may not be relevant for those entities under common control of the parent.

#### Questions for the Private Company Council

1. Does the PCC support Alternative 1 (scope exception)?
2. If the PCC supports Alternative 1, does the PCC agree with the scope of Alternative 1?
3. Alternative 1 is a required exception. Does the PCC agree with requiring private companies from not applying the VIE guidance or, alternatively, does the PCC think it should be an option?
4. If the PCC does not support Alternative 1, what other alternatives does the PCC recommend?

## **Simplification and Reorganization of Topic 810 Guidance for All Entities (Public and Private)**

35. At the meeting when this issue was considered for the FASB agenda in February 2016, the Board discussed whether financial reporting issues related to consolidation guidance should be included in the Board's Agenda Discussion Paper. As discussed at that meeting, respondents to the 2015 FASAC survey indicated that consolidation guidance, particularly the VIE guidance, is difficult to understand and apply. Also, some suggested rewriting the guidance in "Plain English" to simplify it and make it easier to comprehend. At that meeting, the Board decided not to add the topic of consolidation to the Agenda Discussion Paper and, instead, decided to add a separate research project to its agenda. The Board asked the staff to research whether:
- a. Reorganizing Topic 810 would make the Topic easier to navigate and understand
  - b. Any specific areas of the guidance (for example, terms and concepts) could be simplified to make the guidance easier to understand and apply without significantly affecting outcomes reached under the guidance as currently written.
36. The staff has drafted two preliminary documents that show how the guidance would be reorganized to make it easier to understand and apply. The draft includes changes to the introduction and background to make it easier to understand the concept of consolidation holistically and primarily under the VIE model (including determining whether an entity is a VIE or not) and the voting interest model (VOE). The VOE guidance would include limited partnerships and other similar entities that are not determined to be VIEs. One path would have both the VIE guidance and the VOE guidance in the same sections while the other path would segregate the two models. Specific to the first path, a single Subtopic would have VIE guidance preceding the VOE guidance and would start by first determining whether a reporting entity has a variable interest in another entity followed by determining whether the entity is a VIE. The remainder of the guidance for consolidation of VIEs and VOEs would follow within that single subtopic. The second path would segregate the two models into two subtopics and repeat the guidance in each for

determining whether a reporting entity has a variable interest and, if it does have a variable interest, for determining whether the entity is a VIE before applying the VOE model.

37. Under either path, the guidance would be the same. In other words, the staff is not proposing any changes to the language when reorganizing the Topic 810 but, rather, attempting to make the flow of Topic 810 easier to navigate and apply.
38. The staff also proposes eliminating, under both paths, the guidance currently in Topic 810 specific to entities controlled by contract and will seek comment as to whether that guidance is still used in practice, and, if so, whether it is appropriate.
39. The staff also will bring to the Board key terms and concepts that may require simplification because they have been historically considered too complex and may be applied in a manner that isn't exactly what was intended in Topic 810, to get to an appropriate conclusion.
40. Broadly, many of the concepts stress *expected*, *losses*, *expected residual returns*, and *expected variability*. As currently written, embedded in these concepts is a quantitative analysis. However, in determining which reporting entity is the primary beneficiary of a VIE or whether a fee is a variable interest, a quantitative analysis (made on the basis of mathematical considerations required in FASB Concepts Statement No. 7, *Using Cash Flow Information and Present Value in Accounting Measurements*) is not allowed to be determinative in the conclusion of whether an entity is the primary beneficiary of a VIE or whether a fee paid to a decision maker is a variable interest. Those determinations are required to be made on the basis of a qualitative analysis. The specific items that the staff is considering for simplification are as follows:
  - a. The power to direct the activities of a VIE that most significantly impact the VIE's performance must come from a variable interest
  - b. The definitions of expected losses, expected residual returns, expected variability, and variable interests.

### Questions for the Private Company Council

5. Does the PCC support the recommendation that Topic 810 should be reorganized for better navigation?

6. Which alternative would the PCC support for reorganizing Topic 810 – An alternative that provides further clarity of the VIE and VOE guidance within one Subtopic or an alternative that keeps the VIE and VOE guidance separate and in their own Subtopics?

7. Are there terms or concepts that you have encountered in the VIE guidance that are too complex to understand? Please provide an example of that situation.

### **Related Party Guidance for Entities under Common Control Specific to VIEs and Specific to Public Business Entities**

**(This section should be considered only in the context of the questions about how any type of scope exception for private companies may compare to how the guidance may be applied by public business entities, whereby the guidance for common control arrangements may also change from their viewpoint)**

41. In February 2015, the Board issued Accounting Standards Update No. 2015-02, *Consolidation (Topic 810): Amendments to the Consolidation Analysis*. Upon the effective date of Update 2015-02, a single decision maker of a VIE is required to consider indirect economic interests in the entity held through related parties on a proportionate basis when determining whether it is the primary beneficiary of that VIE unless the single decision maker and its related parties are under common control. If a single decision maker and its related parties are under common control, the single decision maker is required to consider indirect interests in the entity held through those related parties to be the equivalent of direct interests in their entirety.
42. After Update 2015-02 was issued, stakeholders noted that by requiring a single decision maker, in circumstances that involve common control, to attribute interests held by certain of its related parties entirely to itself, the single decision maker may be required to consolidate a VIE even if it has little to no direct economic interests in the VIE.
43. For that reason, the Board decided on January 20, 2016 to amend this requirement by deleting the last sentence of paragraph 810-10-25-42. As a result, when determining whether a single decision maker is the primary beneficiary, a single decision maker no

longer would be required to consider indirect interests held through related parties that are under common control with the single decision maker to be the equivalent of direct interests in their entirety and, instead, would include those interests on a proportionate basis consistent with indirect interests held through other related parties. The Board affirmed this decision on August 24, 2016, and directed the staff to draft a final Update for vote by written ballot.

44. The Board received 18 comment letters as part of the review process for the proposed Update. All of the respondents were supportive of the Board's proposal. Several respondents requested that the Board address the interaction of the changes in the proposed Update and the application of the "fees paid to decision makers or service providers" guidance in paragraph 810-10-55-37D, the "related party tie breaker analysis" in paragraphs 810-10-25-42 through 25-44A, and the "most closely associated guidance."
45. Some respondents suggested addressing these issues in the proposed Update. However, the Board determined that it would be more efficient to issue the final Update that was approved on August 24, 2016, and explore additional questions in a separate initiative. To that end, the staff has recently conducted outreach with the Big 4 accounting firms and other stakeholders regarding these additional subject areas in combination with outreach related to the Simplification and Reorganization of Topic 810 and Private Company Considerations for Common Control Arrangements.
46. The alternative currently being developed by the staff for common control arrangements to be applied by public business entities (assuming private companies have a scope exception) is to eliminate the related party tie-breaker test such that every legal entity's contractual rights and exposure of the economics stands on its own; however, the parent company would consolidate the legal entity when, collectively through its commonly controlled entities, it holds a controlling financial interest in the VIE.
47. As described in the "Simplification and Reorganization of Topic 810 Guidance for All Entities (Public and Private)" section above, the staff will be bringing a complete summary of its research and its findings to the Board in the near future on the issues and on other issues discussed in this memo. The information described in that section is

presented to provide a more complete picture of the staff's research activities on these consolidation topics.

48. The staff believes that eliminating the tie-breaker test in Topic 810 for entities under common control and situations in which shared power exists would generally yield similar results for public and private companies (private companies through a scope exception). The reason for the difference in application between private companies and public business entities was noted in paragraph 16 above.

## Appendix A: VIE Guidance Summary

### *VIE Guidance Summary*

A.1 Unless a scope exception exists, a reporting entity first must apply the provisions of the VIE model. If an entity is deemed not to be a VIE or is otherwise exempt from the VIE model, a reporting entity would then apply the provisions of the voting interest model.

A.2. In the first step in applying the variable interest model, a reporting entity is required to determine whether it has a variable interest in an entity. Simply put, a variable interest is an economic arrangement that gives a reporting entity the right to the economic risks or rewards of another entity. For example, traditional equity and debt guarantees are considered to be variable interests. Fees received by decision makers or service providers may represent variable interests depending on the facts and circumstances.

A3. If a reporting entity has a variable interest, the reporting entity then must assess whether the entity is a VIE. The VIE model considers an entity to be a VIE if, by design, *any* one of the following characteristics (paragraph 810-10-15-14) is met:

- a. The entity does not have sufficient equity investments at risk to finance its activities without additional subordinated financial support.
- b. The equity holders, as a group, lack the characteristics of a controlling financial interest
- c. The equity holders have (i) voting rights that are not proportional to their obligation to absorb losses or their right to receive expected residual returns and (ii) activities substantially all of which either involve or are conducted on behalf of the equity investor who has disproportionately few voting rights.

A4. If a reporting entity has a variable interest in a VIE, then the reporting entity must determine whether it is the primary beneficiary of the VIE (that is, the reporting entity that consolidates the VIE). The primary beneficiary is defined as the variable interest holder that has (a) the power to direct the activities that most significantly affect the economic performance of the VIE, and (b) the obligation to absorb losses or the right to receive benefits of the VIE that could be potentially significant to the VIE (paragraph 810-10-25-38A). When performing the

primary beneficiary assessment, it is important to note that the amendments in Update 2015-02 require a reporting entity to include its direct economic interests in the entity and its indirect economic interests in the entity held through related parties considered on a proportionate basis. Indirect interests held through related parties that are under common control with the decision maker should be considered the equivalent of direct interests in their entirety. **Note:** In August 2016, the Board completed its redeliberations and plans to issue a final Update in the coming months that amends the guidance such that indirect interests held through related parties that are under common control with the decision maker should be considered on a proportionate basis, not in their entirety.

*Related Party Tie-Breaker Test*

A5. If the reporting entity concludes that it is not the primary beneficiary, it may need to identify the entity most closely associated with the VIE (generally referred to as the related party tie-breaker). Under Update 2015-02, the related party "tie-breaker" test is applied when the reporting entity and its related parties are under common control and, as a group, the reporting entity along with its related parties have the characteristics of a primary beneficiary:

**810-10-25-44** The guidance in this paragraph shall be applicable for situations in which the conditions in paragraph 810-10-25-44A have been met or when power is shared for a VIE. In situations in which a reporting entity concludes that neither it nor one of its related parties has the characteristics in paragraph 810-10-25-38A but, as a group, the reporting entity and its related parties (including the de facto agents described in paragraph 810-10-25-43) have those characteristics, then the party within the related party group that is most closely associated with the VIE is the primary beneficiary. The determination of which party within the related party group is most closely associated with the VIE requires judgment and shall be based on an analysis of all relevant facts and circumstances, including all of the following:

- a. The existence of a principal-agency relationship between parties within the related party group
- b. The relationship and significance of the activities of the VIE to the various parties within the related party group
- c. A party's exposure to the variability associated with the anticipated economic performance of the VIE
- d. The design of the VIE.

**810-10-25-44A** In situations in which a single decision maker concludes, after performing the assessment in paragraph 810-10-25-42, that it does not have the characteristics in paragraph 810-10-25-38A, the single decision maker shall apply the guidance in paragraph 810-10-25-44 only when the single decision maker and one or more of its related parties are under common control and, as a group, the single decision maker and those related parties have the characteristics in paragraph 810-10-25-38A.

## **Appendix B: Summary of Previous Outreach Conducted (November 2015)**

### ***Practitioner Outreach***

B1. The FASB staff's outreach included practitioners from the large, regional, and midsize accounting firms. Practitioners from the large accounting firms serve public and private companies while the regional and midsize accounting firms serve primarily private companies.

B2. Practitioners included in the staff's outreach were provided with a private company fact pattern of two entities under common control. In that scenario, Owner owns 100 percent of the equity in both Car Co. and Engine Inc. Historically, Car Co. has bailed out Engine Inc. in times of financial trouble. Engine Inc. was established primarily with the intent of vertical integration with Car Co., and it is selling 90 percent of the engines it produces to Car Co. The practitioners were asked to apply VIE guidance to this scenario and answer the following questions:

- a. Assume Car Co. must prepare financial statements to satisfy its debt covenant. Would you consider Engine Inc. to be a VIE? Why or why not?
- b. Now assume that Engine Inc. is a VIE. Who is the primary beneficiary? Please explain your choice.
- c. Do you find applying the VIE guidance to this scenario problematic? Please explain why.
- d. Based on your experience, do you believe that there is diversity in practice when applying VIE guidance to scenarios such as this one?

B3. Most respondents indicated that Engine Inc. would likely be a VIE, citing insufficient capitalization as a primary reason. Other respondents indicated they would need more information before they could make a full assessment. Furthermore, all respondents indicated that Car Co.'s historical bailouts would likely represent an implicit variable interest. Each respondent stated that Car Co. would likely be the primary beneficiary, but also acknowledged that some arguments exist for Owner being the primary beneficiary. The diversity in practice appeared to be much more common with regional or midsized accounting firms as opposed to the larger, national firms.

### *User Feedback*

B4. Users of private company financial statements were presented with a series of three scenarios of entities under the common control of one owner with varying levels of vertical integration similar to the scenario presented to practitioners. They were asked whether consolidated financial statements would represent better financial reporting than standalone financial statements and were given a list of different factors to consider. The scenarios and factors that were used for this outreach were intended to test varying levels of power and economics. They are presented in Appendix D.

### *Demographics of Users*

B6. In the Private Company Decision-Making Framework (the Guide), the types of “primary users” of private company financial statements include investors, lenders, and other creditors, such as sureties. As such, outreach was conducted with lenders, investors, and sureties that primarily worked with private company clients. A majority of the users work with clients with revenues between \$20 million and \$100 million. The industries serviced by the users varied; though contractors, manufacturing, and technology were common. One industry that was not represented in the user outreach was private financial institutions.

### *Feedback Received*

B7. Most users indicated they generally preferred consolidation when power was present (that is, shared management, off-market pricing of products, and so forth) with some level of economic exposure. One user indicated that they preferred consolidation whenever significant economics were present even if power was not. Those who did not generally prefer consolidation said that the entities should never consolidate or that the hurdle for consolidation should be extremely high.

B8. When asked whether they preferred consolidated financial statements or two sets of standalone financial statements from the sibling entities, most users indicated they preferred consolidated financial statements due to the difficulty of manually consolidating two separate standalone statements. Many users also indicated that they typically ask for consolidating statements in addition to consolidated statements; though they do not require the consolidating statements to be audited.

B9. For the Engine Co. example, most users preferred consolidation when the following factors were present (either in combination or in isolation):

- a. Fifty-percent or more of the engines produced were sold to Car Co. (some quoted percentages much lower than 50 percent)
- b. Shared key decision-makers or executive management
- c. Variable pricing of the engines
- d. Common control (for example, under one owner or having each spouse owning an entity).

B10. When presented with the Tire Co. example, many users indicated that the commodity-nature of the input did not have a major effect on their analysis, though a few indicated it could have an effect in varied circumstances. As such, many of the responses to the factors were identical to responses for Engine Co.

B11. For the Purse Co. example, most users indicated that they preferred deconsolidation unless there were many shared resources, such as key decision-makers. If frequent transactions occurred between the sibling entities, then some users indicated they might prefer consolidation in those circumstances, too. However, all users indicated that any of the aforementioned circumstances (that is, shared resources, shared key decision-makers, or frequent intercompany transactions) would be unlikely for situations similar to the Purse Co. example. Finally, a few respondents indicated that they would still prefer consolidation given that Car Co. could control Purse Co., and they were concerned about the economic exposure from historical bailouts or contractual guarantees.

B12. Overall, it was quite clear from users that consolidation was generally preferred for entities under common control when the reporting entity had power over the sibling entity and had some form of economic exposure.

## Appendix C

C1. This appendix provides the slides used to conduct outreach with users.

**Potential Paths**

- Path 1 - No consolidation**
  - Amend VIE guidance not to require consolidation and provide additional disclosures
- Path 2 - New Model for Common Control**
  - Determine when consolidation or combination is necessary

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2

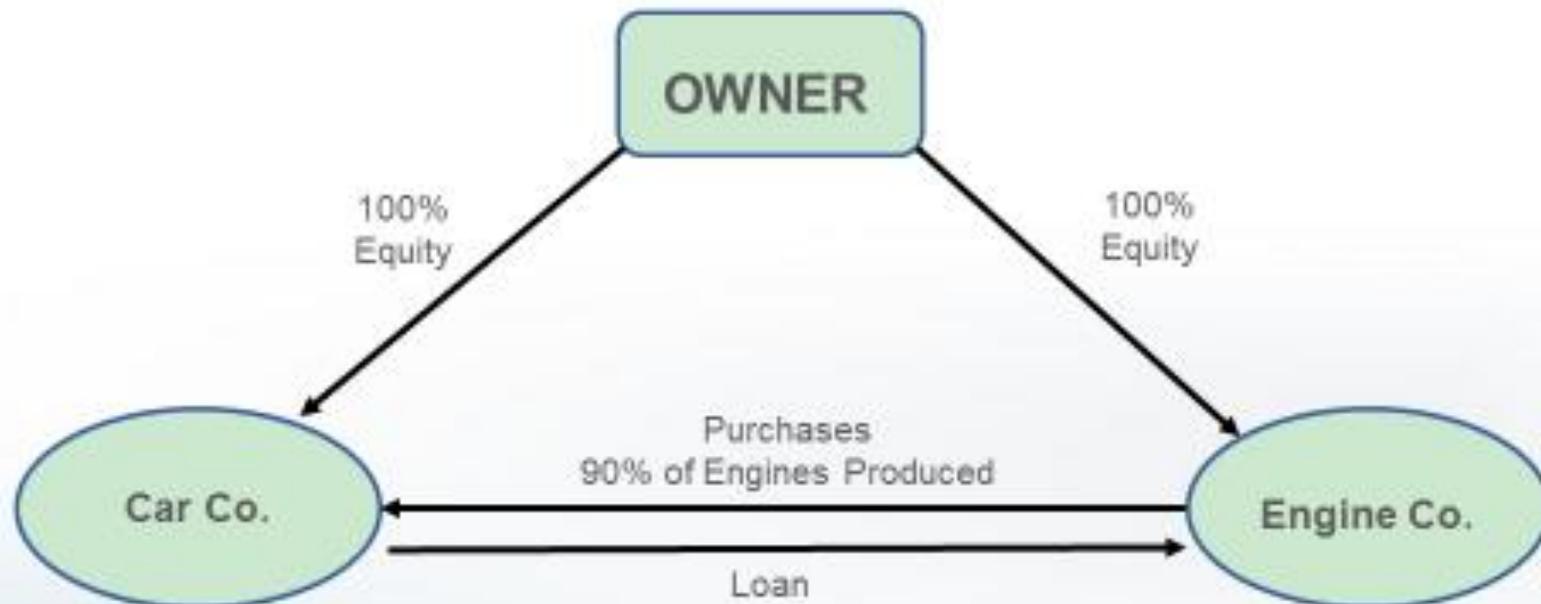
## Research on Path 1 – No consolidation

Entities under common control would not be consolidated



Rely on Disclosures (leverage existing VIE and Related Party Disclosures)

## Engine Co. Example



- Engine Co. has insufficient equity (Equity = 5% of funding)
  - Industry standard for sufficient equity is 20%
- Loan to Engine Co. represents 15% of funding
- Engine Co. financed remaining 80% with Bank ABC
- Car Co. makes significant decisions
- Arms-length pricing

# Car Co / Engine Co / Tire Co Example Disclosures – Refer to attached PDF

## Questions

- If Car Co did not consolidate Engine Co:
  - Would the existing VIE and Related Party disclosures be sufficient?
  - Is there too much disclosure?
- Should there be an option to combine entities under common control?

# Appendix A - VIE Disclosures – 810-10-50-2AA

## > Nonpublic Entities

**50-2AA** The principal objectives of this Subsection's required disclosures are to provide financial statement users with an understanding of all of the following:

- a. The significant judgments and assumptions made by a reporting entity in determining whether it must do any of the following:
  1. Consolidate a variable interest entity (VIE)
  2. Disclose information about its involvement in a VIE.
- b. The nature of restrictions on a consolidated VIE's assets and on the settlement of its liabilities reported by a reporting entity in its statement of financial position, including the carrying amounts of such assets and liabilities.
- c. The nature of, and changes in, the risks associated with a reporting entity's involvement with the VIE.
- d. How a reporting entity's involvement with the VIE affects the reporting entity's financial position, financial performance, and cash flows.

# Appendix A - VIE Disclosures – 810-10-50-4

## VI in a VIE but not the PB

### > Nonprimary Beneficiary Holder of a Variable Interest in a VIE

**50-4** In addition to disclosures required by ~~other guidance, a reporting entity that holds a variable interest in a VIE, but is not the VIE's primary beneficiary,~~ shall disclose:

- a. The carrying amounts and classification of the assets and liabilities in the reporting entity's statement of financial position that relate to the reporting entity's variable interest in the VIE.
- b. The reporting entity's maximum exposure to loss as a result of its involvement with the VIE, including how the maximum exposure is determined and the significant sources of the reporting entity's exposure to the VIE. If the reporting entity's maximum exposure to loss as a result of its involvement with the VIE cannot be quantified, that fact shall be disclosed.
- c. ~~A tabular comparison of the carrying amounts of the assets and liabilities, as required by (a) above, and the reporting entity's maximum exposure to loss, as required by (b) above. A reporting entity shall provide qualitative and quantitative information to allow financial statement users to understand the differences between the two amounts. That discussion shall include, but is not limited to, the terms of arrangements, giving consideration to both explicit arrangements and implicit variable interests, that could require the reporting entity to provide financial support (for example, liquidity arrangements and obligations to purchase assets) to the VIE, including events or circumstances that could expose the reporting entity to a loss.~~
- d. Information about any liquidity arrangements, guarantees, and/or other commitments by third parties that may affect the fair value or risk of the reporting entity's variable interest in the VIE is encouraged.
- e. If applicable, significant factors considered and judgments made in determining that the power to direct the activities of a VIE that most significantly impact the VIE's economic performance is shared in accordance with the guidance in paragraph [810-10-25-38D](#).

# Appendix A - Related Party Disclosures – 850-10-50-1 to 4

## > Related Party Transactions

**60-1** Financial statements shall include disclosures of material related party transactions, other than compensation arrangements, expense allowances, and other similar items in the ordinary course of business. However, disclosure of transactions that are eliminated in the preparation of consolidated or combined financial statements is not required in those statements. The disclosures shall include:

- a. The nature of the relationship(s) involved
- b. A description of the transactions, including transactions to which no amounts or nominal amounts were ascribed, for each of the periods for which income statements are presented, and such other information deemed necessary to an understanding of the effects of the transactions on the financial statements
- c. The dollar amounts of transactions for each of the periods for which income statements are presented and the effects of any change in the method of establishing the terms from that used in the preceding period
- d. Amounts due from or to related parties as of the date of each balance sheet presented and, if not otherwise apparent, the terms and manner of settlement
- e. The information required by paragraph [740-10-50-17](#).

**60-2** Notes or accounts receivable from officers, employees, or affiliated entities must be shown separately and not included under a general heading such as notes receivable or accounts receivable.

**60-3** In some cases, aggregation of similar transactions by type of related party may be appropriate. Sometimes, the effect of the relationship between the parties may be so pervasive that disclosure of the relationship alone will be sufficient. If necessary to the understanding of the relationship, the name of the related party shall be disclosed.

**60-4** It is not necessary to duplicate disclosures in a set of separate financial statements that is presented in the financial report of another entity (the primary reporting entity) if those separate financial statements also are consolidated or combined in a complete set of financial statements and both sets of financial statements are presented in the same financial report.

## Appendix A - Related Party Disclosures – 850-10-50-5 to 6

### > Disclosures About Arm's-Length Bases of Transactions

**50-5** Transactions involving related parties cannot be presumed to be carried out on an arm's-length basis, as the requisite conditions of competitive, free-market dealings may not exist. Representations about transactions with related parties, if made, shall not imply that the related party transactions were consummated on terms equivalent to those that prevail in arm's-length transactions unless such representations can be substantiated.

### > Control Relationships

**50-6** ~~If the reporting entity and one or more other entities are under common ownership or management control and the existence of that control could result in operating results or financial position of the reporting entity significantly different from those that would have been obtained if the entities were autonomous, the nature of the control relationship shall be disclosed even though there are no transactions between the entities.~~

## Appendix D: Car Co / Engine Co / Tire Co Example Disclosures

### NOTE XX - Summary of Significant Accounting Policies

The Company consolidates all wholly owned and majority owned subsidiaries. However, the Company has elected an accounting alternative not to apply VIE guidance to entities under common control. This accounting alternative requires additional disclosures about entities under common control, which is discussed in Note YY – Transactions with Related Parties.

### Note YY - Transactions with Related Parties

Engine Company, Inc. (“*Engine Co.*”): Engine Co. and the Company are under common ownership. Engine Co. was created by the owner in an effort to vertically integrate the supply chain for the Company’s production of vehicles. Engine Co. produces engines for the Company’s vehicles in accordance with the Company’s design specifications for those engines. Substantially all of Engine Co.’s production is sold to the Company, and Engine Co. is the sole supplier of engines to the Company. The Company provides Engine Co. with management and other services (including but not limited to accounting, billing, and administrative duties), for which it charged a management fee of \$225,684 in 2014. The Company purchased \$9,482,513 of engines during 2014 from Engine Co. Engine Co. has an outstanding loan in the amount of \$600,000 due to the Company that is unsecured and accrues interest at 6.00 percent. The loan is subordinated to all other debt and there are no specific repayment terms.

Tire Company, Inc. (“*Tire Co.*”): Tire Co. and the Company are under common ownership. Tire Co. was created by the owner in an effort to vertically integrate the supply chain for the Company’s production of vehicles. Tire Co. produces tires for the Company’s vehicles and sells a majority of those tires to the Company. The Company does not provide design specifications for the tires, however, it does provide Tire Co. with management and other services (including but not limited to accounting, billing, and administrative duties), for which it charged a management fee of \$74,568 in 2014. Car Company purchased \$3,792,929 of tires during 2014 from Tire Co. Tire Co. has an outstanding loan in the amount of \$200,000 due to the Company that is unsecured and accrues interest at 6.00%. The loan is subordinated to all other debt and there are no specific repayment terms.

Both Engine Co. and Tire Co. have third-party debt and both companies have their assets pledged as collateral for that debt. The common owner of the Company, Engine Co., and Tire Co. has personally guaranteed the third-party debt of the Company, Engine Co. and Tire Co.

In addition to the \$600,000 loan, the Company has historically been required to provide funds to Engine Co. at the request of the common owner. The Company believes its maximum financial exposure to loss could equal all of Engine Co.’s liabilities. The book value of Engine Co.’s liabilities is \$2,459,127 as of December 31, 2014.

Other than the \$200,000 loan, the Company has never provided any other additional funding to Tire Co., and is not contractually obligated to do so. The Company believes its maximum financial exposure is limited to the \$200,000 loan outstanding and any accrued interest as of December 31, 2014.

# Private Company VIE Path Timeline

