

**Private Company Council**

**PCC Issue No. 2**

**Title:** Applying Variable Interest Entity Guidance to Common Control Leasing Arrangements

**Document:** Issue Summary No. 1\*

**PCC Meeting Date:** May 7, 2013

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**Dates previously discussed:** February 12, 2013

**Previously distributed PCC materials:** Agenda Request Issue No. 2, dated February 12, 2013

**Background**

1. At its February 12, 2013 meeting, the PCC voted to add a project to its agenda to address the application of variable interest entity guidance in related party leasing arrangements. After further outreach and research, the staff believes that a more appropriate project scope is leasing arrangements between private companies under common control (common control leasing arrangements). In common control scenarios the common owner has power over the operations and flow of resources of both entities in the related party leasing arrangement.
2. The purpose of this memorandum is to discuss the issues associated with applying variable interest entity (VIE) guidance to leasing arrangements between private companies under common control and to get direction from the PCC on how to address those issues.

**Implicit Variable Interest and Related Party Leasing Arrangements**

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\* The alternative views presented in this Issue Summary are for purposes of discussion by the PCC. No individual views are to be presumed to be acceptable or unacceptable applications of Generally Accepted Accounting Principles until the PCC makes such a determination, exposes it for public comment, and it is endorsed by the Board.

3. FASB Staff Position No. FIN 46(R)-5, *Implicit Variable Interests under FASB Interpretation No. 46 (revised December 2003)*, Consolidation of Variable Interest Entities, was issued in March 2005 (and is included as Appendix A). In an FASB staff memorandum (dated October 18, 2004) supporting FSP FIN 46(R)-5, the staff stated that:

There appears to be diversity in practice with respect to whether a party must consider whether an indirect implicit variable interest exists when applying the provisions of FIN 46(R). This issue is important since a party that concludes it holds no variable interest (implicit or explicit) in a VIE would not apply FIN 46(R).

4. The guidance in FSP FIN 46(R)-5 (codified in paragraphs 810-10-25-48 through 25-54, and paragraphs 810-10-55-88 through 55-89) was intended to provide additional guidance for identifying implicit variable interest. FSP FIN 46(R)-5 provided the following example (excerpts), hereinafter referred to as the FSP example, of an implicit variable interest:

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 (previously paragraph B24 of Interpretation 46(R)). The lease meets the classification requirements for an operating lease and is the only contractual relationship between Manufacturing Entity and 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.

... 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.

... 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.

5. In the memorandum, the staff also stated that without the guidance in FSP FIN 46(R)-5, there would exist a great deal of opportunity to circumvent the application of FIN 46(R) by structuring a transaction to directly protect the interest holder in a VIE as opposed to the VIE itself. FSP FIN 46(R)-5 suggests that the Manufacturing Entity (Operating Entity) may in certain circumstances have an implicit guarantee on Leasing Entity's debt (that is, a variable interest in Leasing Entity). If Manufacturing Entity has an implicit variable interest (that is, a guarantee on the debt) and the Leasing Entity is a VIE, then the Manufacturing Entity and its owner as a related party group is generally considered to be the primary beneficiary.

6. However, only one party in a related party group can be the primary beneficiary. Paragraph 810-10-25-44, provided below, states that the party within the related party group that is most closely associated with the VIE is the primary beneficiary. When performing this assessment, constituents place heavier weighting on criterion (b); "the relationship and significance of the activities of the variable interest entity to the various parties within the related party group." As a result of criterion (b), the Manufacturing Entity is generally considered to be the primary beneficiary because the leasing activity primarily benefits the Manufacturing Entity. As a result of the FSP example, many constituents assumed that similar leasing arrangements between entities under common control should always result in the Manufacturing Entity consolidating the lessor VIE Entity.

**810-10-25-44** 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 the preceding paragraph) 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.

## Scope

7. This Issue applies to all nonpublic entities<sup>1</sup> applying variable interest entity guidance in Subtopic 810-10, Consolidation—Overall, to common control leasing arrangements.

## Feedback/Private Company Decision-Making Framework Analysis

8. The FASB staff evaluated VIE guidance in Subtopic 810-10 for common control leasing arrangements under the recognition and measurement module of the proposed Private Company Decision Making Framework (the Guide) to determine whether the consolidated financial statements of the lessee entity provide relevant information to its users at a reasonable cost. The staff notes that the Guide places more weight on the overall response to questions that address user relevance.

9. The *primary* users of private company financial statements (lenders) have stated that they do not find consolidating a related party leasing entity (lessor) with a manufacturing entity (lessee) to be useful. Most private company lenders believe that the consolidation of the lessor distorts the financial statements of the lessee. Those users often have to make adjustments to the lessee's financial statements for their analysis by requesting a "consolidating" schedule. Accordingly, the FASB staff believes that VIE guidance for common control leasing arrangements does not provide user-relevant information.

10. Some private company users, such as sureties, find consolidation of the related party lessor entity to be useful. However, sureties have expressed the most interest in the terms of the debt

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<sup>1</sup> The term *nonpublic entity* is used in this memorandum with the same meaning as the term *nonpublic entity* in Topic 715, Compensation—Retirement Benefits, and also does not include not-for-profit entities. Topic 715 defines a nonpublic entity as:

An entity that does not meet any of the following criteria:

- a. Its debt or equity securities are traded in a public market, including those traded on a stock exchange or in the over-the-counter market (including securities quoted only locally or regionally).
- b. It is a conduit bond obligor for conduit debt securities that are traded in a public market (a domestic or foreign stock exchange or an over-the-counter market, including local or regional markets).
- c. Its financial statements are filed with a regulatory agency in preparation for the sale of any class of securities.

issued by the lessor; this is especially true when the performance of a bonded project relies on collateralized equipment or property held by the lessor. Sureties have also stated that robust disclosures or the lessor's summary financial statements could be sufficient in instances in which the related party lessor entity is not consolidated. Some sureties also indicated they have access to management and the owners of private companies. Therefore, the FASB staff believes that robust disclosures in the lessee's financial statements about nonconsolidated related-party lessor entities would accommodate the information needs of sureties.

11. The FASB staff noted that VIE guidance for common control leasing arrangements would meet most of the cost and complexity criteria discussed in paragraph 1.6 of the Guide. In other words, the staff believes that VIE guidance for common control leasing arrangements is costly and complex to implement.

12. Since the FASB staff believes that VIE guidance for common control leasing arrangements does not provide user-relevant information and is costly and complex to apply, the staff believes that there is a sufficient basis to consider an alternative for VIE guidance within U.S. generally accepted accounting principles (GAAP).

**Issue 1: Which alternative does the PCC support to address the concerns of private companies in applying variable interest entity guidance in common control leasing arrangements?**

*View A: (Practicability Exception) This alternative would provide private companies with a practicability exception that exempts them from applying VIE guidance to common control leasing arrangements when the reporting entity is leasing from a lessor entity that is under common control and substantially all of the activities of the lessor entity consist of leasing or the support of leasing.*

13. View A would exempt nonpublic reporting entities from applying VIE guidance in Subtopic 810-10 when the reporting entity and the lessor entity are under common control and substantially all of the lessor entity's activities consists of leasing or the support of leasing. The

staff believes that the decision to apply the practicability exception under View A should be an accounting policy election applicable to all of a reporting entity's leasing arrangements within the scope rather than a decision to be applied piecemeal to individual arrangements.

14. Under this approach, more robust disclosures surrounding the lessor entity and its debt (if applicable) would be required. Note that explicit variable interest, such as a guarantee, would not preclude a reporting entity from applying this practicability exception. The following draft paragraphs would be added to the Codification to amend the scope of Subtopic 810-10:

**810-10-15-XX** A legal entity need not be evaluated by a nonpublic entity to determine whether the legal entity is a VIE under the requirements of the Variable Interest Entities Subsections if all of the following criteria are present:

- a. The nonpublic entity and the legal entity are under common control
- b. The nonpublic entity has a lease arrangement with the legal entity
- c. Substantially all of the legal entity's business activities consist of leasing or the support of leasing

Paragraph XXX-XX-XX-XX requires certain disclosures to be made by nonpublic entities subject to this practicability exception.

**810-10-50-XX** A nonpublic entity that does not apply the requirements or the Variable Interest Entities Subsections to one or more VIEs or potential VIEs because they met the criteria described in paragraph 810-10-15-XX, shall disclose all of the following information:

- a. The key terms of the leasing arrangements
- b. Current period rent expense charged by the "related-party lessor" as required in paragraph 840-20-50-1
- c. Future committed lease payments based on a lease agreement, if applicable, as required in paragraph 840-20-50-2a
- d. The amount of debt and/or significant liabilities of the related-party lessor
- e. The key terms of existing debt agreements of the related-party lessor (for example, amount of debt, interest rate, maturity, pledged collateral, and so forth)
- f. The key terms of explicit interest in the leasing entity.

15. The FASB staff stresses that this practicability exception only exempts a nonpublic entity from applying VIE guidance in certain circumstances. The practicability exception does not exempt a nonpublic entity from applying the voting interest or partnership model in Subtopic 810-10. Therefore, because of its direct equity interests in a lessor entity under common control,

the nonpublic entity could be required consolidate the lessor entity through application of the voting interest or partnership model. If no consolidation model applies, then the reporting entity would generally follow leasing guidance to account for the lease with the lessor entity.

16. Proponents of View A believe that it would remove the complexities involved in applying VIE guidance for preparers and practitioners while providing pertinent information to the users of private company financial statements (red-flag approach). This alternative could provide immediate relief to private companies, which many perceive to be long overdue. View A will likely reduce audit costs associated with common control leasing arrangements. Under this approach, the audit effort will likely focus on the leasing arrangement and debt held at the leasing company. Moreover, allowing private companies that hold explicit and implicit interests in the lessor entity to apply the practicability exception broadens the benefitting population. Several respondents during the staff's outreach stated that it is common for the lessee entity to hold explicit interest in the lessor entity, such as a debt guarantee or a long date extension contract. Proponents of View A also believe that a practicability exception creates fewer unintended consequences than creating implementation guidance to clarify VIE guidance for related parties.

17. Opponents of View A believe that providing a practicability exception for private companies within U.S GAAP creates inconsistency in recognition and measurement between private companies and public companies. Proponents of View A however state that because this issue exists primarily among private companies, comparability would not be significantly affected. Opponents of View A state that this practicability exception does not contemplate certain leasing arrangements under common control for which consolidation could provide more user relevant information. Germane to that concern is the ability for private companies to structure around consolidation through the application of this practicability exception. Opponents of View A also argue that it fails to sufficiently address the issue with VIE guidance. By providing a practicability exception to a narrow set of circumstances, VIE guidance may continue to result in consolidation of related party entities that users do not find relevant. These opponents believe in addressing VIE guidance in its totality.

*View A and Impact on the FSP Example*

18. If the PCC concludes on View A, the staff believes that the PCC should recommend removing the FSP example from the Codification in paragraphs 810-10-55-88 through 55-89.

19. View A directly contradicts the FSP example because it exempts private companies with a fact pattern very similar to the FSP example from applying VIE guidance. The staff acknowledges that if the FSP example is removed, there will be no implementation guidance for implicit variable interests in the Codification. However, the staff believes that the FSP example currently does not provide any incremental value because it is ambiguous and rarely analogized to by public companies.

*View B: This alternative would provide implementation guidance on how to identify variable interests in common control leasing arrangements.*

20. In the agenda request for the February 12, 2013 PCC meeting, the staff proposed View B as a potential approach to address VIE guidance in related party leasing arrangements. The staff's objective was to demonstrate through implementation guidance that the common control owner in scenarios similar to the FSP example could assess under FASB Statement No. 167, *Amendments to FASB Interpretation No. 46(R)* (codified as Subtopic 810-10), that it holds the characteristics of a primary beneficiary on its own, and therefore Manufacturing Entity would not consolidate Leasing Entity. However, after outreach and further research the staff determined this is not technically feasible and contradicts certain aspects of the current VIE model.

21. If the PCC would like to pursue View B, the staff believes that a more appropriate focus is on clarifying the identification of variable interests under common control leasing arrangements. View B would require the following changes to existing VIE guidance:

- a. PCC recommends that the Board remove the FSP example from the Codification in paragraphs 810-10-55-88 through 55-89.

- b. PCC recommends that the Board add implementation guidance using a similar fact pattern to the one in the FSP example, but clarify that a variable interest, such as an implied guarantee on the Leasing Entity's debt, does not exist.

22. View B clarifies the confusion on identifying implicit variable interest in private company arrangements similar to the FSP example. View B could spare lessee entities without a variable interest in lessor entities from performing the rest of the VIE assessment. View B takes a position that the FSP example contradicts the overall VIE model and does not appropriately consider purpose and design. View B would conclude that the potential implied guarantee within the FSP example is not a variable interest because it does not create and pass along variability (risk). Paragraph 810-10-25-22 states:

The variability to be considered in applying the Variable Interest Entities Subsections shall be based on an analysis of the design of the legal entity as outlined in the following steps:

- a. Step 1: Analyze the nature of the risks in the legal entity (see paragraphs 810-10-25-24 through 25-25).
- b. Step 2: Determine the purpose(s) for which the legal entity was created and determine the variability (created by the risks identified in Step 1) the legal entity is **designed to create and pass along to its interest holders** (see paragraphs 810-10-25-26 through 25-36). [Emphasis added.]

23. In the FSP example, the owner created Leasing Entity for purposes of leasing the manufacturing facility, its only asset, to Manufacturing Entity. If Manufacturing Entity does not make lease payments, then Leasing Entity is at risk of default on its debt because the lease payments are its only substantive source of income. An implied guarantee on Leasing Entity's debt is primarily absorbing the risk that Manufacturing Entity will not be able to make its lease payments. Because the VIE model stresses that the variability created by one entity is passed along to that entity's interest holders, Manufacturing Entity does not have a variable interest. Manufacturing Entity's implied guarantee on Leasing Entity's debt is not a variable interest because it absorbs a risk created by its holder.

24. The following draft paragraphs would amend the implementation guidance in Subtopic 810-10 to clarify how to identify the variable interest under common control leasing arrangements:

**810-10-55-XX** The sole owner 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-XX** Although the lease agreement itself does not contain a contractual guarantee, 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. However, Manufacturing Entity's implied guarantee on Leasing Entity's debt is not a variable interest because it absorbs a risk created by its holder.

25. Proponents of View B agree with the principles of VIE guidance and believe that this alternative fixes a contradiction within existing VIE guidance. By reinforcing and clarifying the principles of the VIE model, proponents argue that this approach would help both public and private companies. Furthermore, proponents of View B state that this approach will not create recognition and measurement differences within U.S. GAAP.

26. Opponents of View B argue that this approach does not clarify the assessment of explicit variable interest under common control leasing arrangements. Those opponents also believe that this approach could lead to unintended consequences in applying VIE guidance for other arrangements. Opponents of View B argue that clarification of the model would still force private companies whose only VIE arrangement is a common control leasing arrangement to incur the costs of applying the VIE model. Those opponents note that common control leasing arrangements are ubiquitous among private companies and are often their only potential VIE arrangement.

## **Recurring Disclosures**

27. The staff believes that if the PCC concludes on View A, private companies should be required to make the disclosures proposed in paragraph 14 above. Those disclosures will enable the reporting entity to present its financial statements separately from the leasing entity under common control, while still providing transparency into its potential obligations as a result of its arrangement with the leasing entity. Furthermore, the disclosures require that the reporting entity disclose information key terms of any significant obligations held by the leasing entity. The staff believes that this proposal is consistent with the feedback received from users.

28. If the PCC concludes on View B, the staff does not recommend any incremental disclosures to the existing VIE disclosure requirements as described in Section 810-10-50, Consolidation—Overall—Disclosure. View B clarifies a perceived contradiction in the VIE model and does change the accounting and disclosure principles under Topic 810. If a lessee entity determines that it has no variable interest in the lessor entity, then current VIE guidance would require no disclosures on the lessor entity.

### **Transition**

29. Presented below are two transition alternatives for View A and View B of Issue 1:

*Option A: Nonpublic entities should recognize the effect of the change as a change in accounting principle through retrospective application. Nonpublic entities would adjust opening retained earnings for the earliest period presented following deconsolidation guidance provided in paragraph 810-10-65-2(e).*<sup>2</sup>

30. Proponents of Option A observe that the FASB's conceptual framework describes comparability (including consistency) as one of the qualitative characteristics of accounting information. Those proponents refer to paragraph B7 of the Basis for Conclusions in FASB Statement No. 154, *Accounting Changes and Error Corrections*, which states that:

The Board concluded that retrospective application improves financial reporting because it enhances the consistency of financial information between periods. That improved consistency enhances the usefulness of the financial statements, especially by facilitating analysis and understanding of comparative accounting data.

31. Reporting entities that had previously consolidated lessor entities under common control would need to potentially deconsolidate them. Opponents of Option A are concerned with implementation challenges in retrospectively deconsolidating lessor entities.

*Option B: Nonpublic entities should recognize the effect of the change as a change in accounting principle through a modified retrospective application. Nonpublic entities would adjust opening retained earnings for the current period presented following deconsolidation guidance provided in paragraph 810-10-65-2(e).*

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<sup>2</sup> Paragraph 810-10-65-2(e) states:

If a reporting entity is required to deconsolidate a VIE as a result of the initial application of the pending content in the Variable Interest Entities Subsections, the deconsolidating reporting entity shall initially measure any retained interest in the deconsolidated subsidiary at its carrying amount at the date the requirements of the pending content in the Variable Interest Entities Subsections first apply. 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 in the Variable Interest Entities Subsections had been effective when the reporting entity became involved with the VIE or no longer met the conditions to be the primary beneficiary. 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.

32. Proponents of Option B believe that the information needed to retrospectively deconsolidate the lessor entity may not be readily available or determinable in all circumstances. They believe that the costs of getting that information outweigh the benefits of consistency and comparability. Opponents of Option B believe that this approach reduces consistency and comparability in financial reporting. Opponents of Option B also note that Section 250-10-45, Accounting Changes and Error Corrections—Overall—Other Presentation Matters, includes an impracticability exception provision for those situations in which it is impracticable to restate prior periods upon adoption of a new accounting standard.

*Transition—Staff Recommendation*

33. Based on feedback received, the staff does not believe that retrospectively deconsolidating a lessor entity will be burdensome or costly for private companies. Users stated they often request consolidating schedules from a private company, which could be used by preparers to retrospectively adjust the private company's financial statements.

*Transition Disclosures*

34. The other presentation matters guidance in Subtopic 250-10, Accounting Changes and Error Corrections—Overall, is applicable for any voluntary change in accounting principle, including a change in the method of applying an accounting principle. The staff recommends that the PCC propose that companies apply the disclosure requirements in Section 250-10-50 for an accounting change required by this Issue. Additionally, the staff recommends that the PCC not propose any additional disclosures other than the requirements in paragraphs 250-10-50-1 through 250-10-50-3.

## Appendix A

### FASB STAFF POSITION

#### No. FIN 46(R)-5

**Title:** Implicit Variable Interests under FASB Interpretation No. 46 (revised December 2003), *Consolidation of Variable Interest Entities (This FSP is applicable to both nonpublic and public reporting enterprises. This issue commonly arises in leasing arrangements among related parties, and in other types of arrangements involving related parties and unrelated parties.)*

**Date Posted:** March 3, 2005

1. The Board directed the FASB staff to issue this FASB Staff Position (FSP) to address whether a reporting enterprise should consider whether it holds an implicit variable interest in a variable interest entity (VIE) or potential VIE when specific conditions exist.
2. The identification of variable interests (implicit and explicit) may affect (a) the determination as to whether the potential VIE should be considered a VIE, (b) the calculation of expected losses and residual returns, and (c) the determination as to which party, if any, is the primary beneficiary of the VIE. Thus, identifying whether a reporting enterprise holds a variable interest in a VIE or potential VIE is necessary to apply the provisions of Interpretation 46(R).
3. An implicit variable interest is an implied pecuniary interest in an entity that changes with changes in the fair value of the entity's net assets exclusive of variable interests. Implicit variable interests may arise from transactions with related parties, as well as from transactions with unrelated parties. Paragraph B10 of Interpretation 46(R) provides one example of an implicit variable interest; that is, an implicit agreement to replace impaired assets held by a variable interest entity that protects holders of other interests in the entity from suffering losses. However, Appendix B to Interpretation 46(R) is not intended to provide a complete list of all possible variable interests.

4. The identification of explicit variable interests involves determining which contractual, ownership, or other pecuniary interests in an entity directly absorb or receive the variability of the 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 entity, rather than directly from the entity. Therefore, the identification of an implicit variable interest involves determining whether an enterprise may be indirectly absorbing or receiving the variability of the 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 enterprise can be required to protect a variable interest holder in an entity from absorbing losses incurred by the entity. Refer to the example in this FSP.

5. The FASB staff is aware of transactions where a reporting enterprise has an interest in, or other involvement<sup>1</sup> with, a VIE or potential VIE that is not considered a variable interest, and the reporting enterprise's related party<sup>2</sup> holds a variable interest in the same entity. A reporting enterprise's interest in, or other pecuniary involvement with, a VIE may take many different forms such as a lessee under a leasing arrangement or a party to a supply contract, service contract, or derivative contract. For these and other types of transactions, the FASB staff understands that there is diversity in practice as to whether the reporting enterprise should consider whether an implicit variable interest exists between it and the VIE or potential VIE.

6. The FASB staff believes the reporting enterprise should consider whether it holds an implicit variable interest in the VIE or potential VIE. The determination of whether an implicit variable interest exists should be based on all facts and circumstances in determining whether the reporting enterprise may absorb variability of the VIE or potential VIE. A reporting enterprise that holds an implicit variable interest in a VIE and is a related party<sup>3</sup> to other variable interest

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<sup>1</sup> The significance of an enterprise's involvement or interest should not be considered in determining whether the enterprise holds an implicit variable interest in the entity.

<sup>2</sup> For purposes of this FSP, refer to paragraph 16 of Interpretation 46(R) for the definition of related party.

<sup>3</sup> The guidance in this FSP applies to related parties as defined in paragraph 16 of Interpretation 46(R). For example, the guidance in this FSP applies to situations in which (1) a reporting enterprise and a VIE are under common control, (2) a reporting enterprise has an interest in, or other involvement with, a VIE and an officer of that reporting enterprise has a variable interest in the same VIE, or (3) a reporting enterprise 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.

holders should apply the guidance in paragraph 17 of Interpretation 46(R) to determine whether it is the primary beneficiary of the VIE. That is, if the aggregate variable interests held by the enterprise (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 variable interest entity is the primary beneficiary. The determination of which party within the related party group is most closely associated with the variable interest entity requires judgment, and shall be based on an analysis of all relevant facts and circumstances. Paragraph 17 of Interpretation 46(R), provides factors to consider in making that determination. A reporting enterprise that is not the primary beneficiary but holds an implicit variable interest in a VIE should disclose the information in paragraph 24 of Interpretation 46(R).

### **Effective Date and Transition**

7. For entities to which Interpretation 46(R) has been applied, the guidance in this FSP shall be applied in the first reporting period beginning after March 3, 2005 in accordance with the transition provisions of Interpretation 46(R). Restatement to the date of the initial application of Interpretation 46(R) is permitted but not required. Early application is permitted for periods for which financial statements have not yet been issued. For entities to which Interpretation 46(R) has not been applied, the guidance in this FSP shall be applied in accordance with the effective date and transition provisions of Interpretation 46(R).

### **Example**

One of the two owners of Manufacturing Company is also the sole owner of Leasing Company, which is a VIE. The owner of Leasing Company provides a guarantee of Leasing Company's debt as required by the lender. Leasing Company owns no assets other than the manufacturing facility being leased to Manufacturing Company. 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 B24 of Interpretation 46(R). The lease meets the classification requirements for an operating lease and is the only contractual relationship between Manufacturing Company and Leasing Company.

Based on the guidance in this FSP, Manufacturing Company should consider whether it holds an implicit variable interest in Leasing Company.

Although the lease agreement itself does not contain a contractual guarantee, Manufacturing Company should consider whether it holds an implicit variable interest in Leasing Company as a result of the leasing arrangement and the relationship between it and the owner of Leasing Company. For example, Manufacturing Company would be considered to hold an implicit variable interest in Leasing Company if Manufacturing Company effectively guaranteed the owner's investment in Leasing Company.<sup>4</sup> Manufacturing Company may be expected to make funds available to Leasing Company to prevent the owner's guarantee of Leasing Company's debt from being called on, or Manufacturing Company may be expected to make funds available to the owner to fund all or a portion of the call on Leasing Company's debt guarantee. The determination as to whether Manufacturing Company 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, should 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 Company to act as a guarantor or to make funds available, whether such actions have happened in similar situations in the past, and whether Manufacturing Company acting as a guarantor or making funds available would be considered a conflict of interest or illegal.

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<sup>4</sup> The guidance in this FSP should be used only to evaluate whether a variable interest exists under Interpretation 46(R) and should not be used in the evaluation of lease classification in accordance with FASB Statement No. 13, *Accounting for Leases*. Paragraph 29 of Statement 13 addresses leases between related parties and states "...the classification and accounting shall be the same as for similar leases between unrelated parties, except in cases where it is clear that the terms of the transaction have been significantly affected by the fact that the lessee and lessor are related. In such cases the classification and/or accounting shall be modified as necessary to recognize economic substance rather than legal form. The nature and extent of leasing transactions with related parties shall be disclosed."