

FINANCIAL ACCOUNTING SERIES



No. 2014-07
March 2014

Consolidation (Topic 810)

Applying Variable Interest Entities Guidance to
Common Control Leasing Arrangements

a consensus of the Private Company Council

An Amendment of the *FASB Accounting Standards Codification*®

Financial Accounting Standards Board

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Summary

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

The Private Company Council (PCC) added this Issue to its agenda in response to feedback from private company stakeholders indicating that the benefits of applying variable interest entities (VIE) guidance to a lessor entity under common control do not justify the related costs. Private company stakeholders stated that, generally, a common owner establishes a lessor entity separate from the private company lessee for tax, estate-planning, and legal-liability purposes—not to structure off-balance-sheet debt arrangements. In instances in which a lessor entity is consolidated by a private company lessee on the basis of VIE guidance, most users of the private company lessee entity's financial statements stated that consolidation is not relevant to them because they focus on the cash flows and tangible worth of the standalone private company lessee entity, rather than on the consolidated cash flows and tangible worth of the private company lessee entity as presented under U.S. generally accepted accounting principles (GAAP). Those users also stated that consolidation of the lessor entity under common control distorts financial statements of the private company lessee entity because the assets held by the lessor entity would not be available to satisfy the obligations of the lessee entity. They indicated that these assets are beyond the reach of the lessee's creditors, even in bankruptcy or other receivership. Consequently, those users stated that when they receive consolidated financial statements, they often request a consolidating schedule to enable them to reverse the effects of consolidating the lessor entity.

Because the *Private Company Decision-Making Framework: A Guide for Evaluating Financial Accounting and Reporting for Private Companies* (Guide) focuses on user-relevance and cost-benefit considerations for private companies, the PCC decided that the concerns expressed about the cost and complexity of applying VIE guidance and the lack of relevance to users when consolidating lessor entities under common control indicated that a change to VIE guidance should be explored. The PCC reached a consensus to provide an elective accounting alternative for private companies in applying VIE guidance to lessor entities under common control (which the Board endorsed) leading to the issuance of this Update.

Who Is Affected by the Amendments in This Update?

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

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

What Are the Main Provisions?

The amendments permit a private company lessee (the reporting entity) to elect an alternative not to apply VIE guidance to a lessor entity if (a) the private company lessee and the lessor entity are under common control, (b) the private company lessee has a lease arrangement with the lessor entity, (c) substantially all of the activities between the private company lessee and the lessor entity are related to leasing activities (including supporting leasing activities) between those two entities, and (d) if the private company lessee explicitly guarantees or provides collateral for any obligation of the lessor entity related to the asset leased by the private company, then the principal amount of the obligation at inception of such guarantee or collateral arrangement does not exceed the value of the asset leased by the private company from the lessor entity. Examples of supporting leasing activities between the private company lessee and the lessor entity include issuance of a guarantee and provision of collateral on the obligations of the lessor entity that are related to the asset(s) leased to the private company lessee.

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

Under the alternative, a private company lessee would not be required to provide the VIE disclosures about the lessor entity. Rather, the private company lessee would disclose (1) the amount and key terms of liabilities recognized by the lessor entity that expose the private company lessee to providing financial support to the lessor entity and (2) a qualitative description of circumstances not recognized in the financial statements of the lessor entity that expose the private company lessee to providing financial support to the lessor entity. The disclosures under this alternative are required in combination with the disclosures required by other Topics (for example, Topic 460, Guarantees, Topic 840, Leases, and Topic 850, Related Party Disclosures) about the lessee entity's relationship with the lessor entity. Those disclosures could be combined in a single note or by including cross-references within the notes to financial statements. In addition, entities that elect this alternative should continue to apply consolidation guidance other than VIE guidance in Topic 810 as well as other applicable guidance, including Topics 460 and 840.

How Do the Main Provisions Differ from Current U.S. Generally Accepted Accounting Principles (GAAP) and Why Are They an Improvement?

U.S. GAAP requires a reporting entity to consolidate an entity in which it has a controlling financial interest. There are two primary models for assessing whether there is a controlling financial interest: the voting interest model and the VIE model. Under the voting interest model, a controlling financial interest generally is obtained through ownership of a majority of an entity's voting interests. Under the VIE model, a reporting entity is deemed to have a controlling financial interest (that is, deemed to be the primary beneficiary) when it has both (1) the power to direct the activities that most significantly affect the economic performance of the entity and (2) the obligation to absorb losses or the right to receive benefits of the entity that could potentially be significant to the entity. To determine which model applies, a reporting entity must determine whether it has a variable interest and whether the entity being evaluated is a VIE.

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

The Board and the PCC concluded that the accounting alternative, if elected, has the potential to improve financial reporting for the users of private company financial statements while reducing the cost and complexity associated with applying VIE guidance to lessor entities under common control. Most users of private company financial statements stated that the consolidation of lessor entities under common control distorts financial statements of private company lessee entities. The Board and the PCC also concluded that the disclosures under this alternative provide useful information related to these lessor entities without the cost and complexity of applying VIE guidance.

The Board and the PCC concluded that the accounting alternative for applying VIE guidance to common control lessor entities is responsive to the needs of private companies and that it will continue to provide decision-useful information to the users of private company financial statements, while providing a reduction in the cost and complexity associated with application of the VIE guidance. Therefore, the amendments meet the overall objective of the Guide for addressing the needs of private company stakeholders.

When Will the Amendments Be Effective?

If elected, the accounting alternative should be applied retrospectively to all periods presented. The alternative will be effective for annual periods beginning after December 15, 2014, and interim periods within annual periods beginning after December 15, 2015. Early application is permitted, including application to

any period for which the entity's annual or interim financial statements have not yet been made available for issuance.

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

Introduction

1. The Accounting Standards Codification is amended as described in paragraphs 2–10. In some cases, to put the change in context, not only are the amended paragraphs shown but also the preceding and following paragraphs. Terms from the Master Glossary are in **bold** type. Added text is underlined, and deleted text is ~~struck out~~.

Amendments to Master Glossary

2. Add the following Master Glossary terms to Subtopic 810-10 as follows:

Financial Statements Are Available to Be Issued

Financial statements are considered available to be issued when they are complete in a form and format that complies with GAAP and all approvals necessary for issuance have been obtained, for example, from management, the board of directors, and/or significant shareholders. The process involved in creating and distributing the financial statements will vary depending on an entity's management and corporate governance structure as well as statutory and regulatory requirements.

Private Company

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

Public Business Entity

A public business entity is a business entity meeting any one of the criteria below. Neither a **not-for-profit entity** nor an employee benefit plan is a business entity.

- a. It is required by the U.S. Securities and Exchange Commission (SEC) to file or furnish financial statements, or does file or furnish financial statements (including voluntary filers), with the SEC (including other entities whose financial statements or financial information are required to be or are included in a filing).

- b. It is required by the Securities Exchange Act of 1934 (the Act), as amended, or rules or regulations promulgated under the Act, to file or furnish financial statements with a regulatory agency other than the SEC.
- c. It is required to file or furnish financial statements with a foreign or domestic regulatory agency in preparation for the sale of or for purposes of issuing securities that are not subject to contractual restrictions on transfer.
- d. It has issued, or is a conduit bond obligor for, securities that are traded, listed, or quoted on an exchange or an over-the-counter market.
- e. It has one or more securities that are not subject to contractual restrictions on transfer, and it is required by law, contract, or regulation to prepare U.S. GAAP financial statements (including footnotes) and make them publicly available on a periodic basis (for example, interim or annual periods). An entity must meet both of these conditions to meet this criterion.

An entity may meet the definition of a public business entity solely because its financial statements or financial information is included in another entity's filing with the SEC. In that case, the entity is only a public business entity for purposes of financial statements that are filed or furnished with the SEC.

Amendments to Subtopic 810-10

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

Consolidation—Overall

Scope and Scope Exceptions

Variable Interest Entities

> Accounting Alternative

810-10-15-17A A legal entity need not be evaluated by a private company under the guidance in the Variable Interest Entities Subsections if criteria (a) through (c) are met and, in applicable circumstances, criterion (d) is met:

- a. The private company lessee (the reporting entity) and the lessor legal entity are under common control.
- b. The private company lessee has a lease arrangement with the lessor legal entity.

- c. Substantially all activities between the private company lessee and the lessor legal entity are related to leasing activities (including supporting leasing activities) between those two entities.
- d. If the private company lessee explicitly guarantees or provides collateral for any obligation of the lessor legal entity related to the asset leased by the private company, then the principal amount of the obligation at inception of such guarantee or collateral arrangement does not exceed the value of the asset leased by the private company from the lessor legal entity.

See paragraph 810-10-55-9 and paragraphs 810-10-55-205A through 55-205I for implementation guidance.

810-10-15-17B Application of this accounting alternative is an accounting policy election that shall be applied by a private company to all legal entities, provided that all of the criteria for applying this accounting alternative specified in paragraph 810-10-15-17A are met. For lessor legal entities that as a result of this accounting alternative are excluded from applying the guidance in the Variable Interest Entities Subsections, a private company lessee shall continue to apply other accounting guidance (including guidance in the General Subsections of this Subtopic and guidance included in Subtopic 810-20 on control of partnerships and similar entities) as applicable. A private company that elects this accounting alternative shall disclose the required information specified in paragraph 810-10-50-2AD unless the lessor legal entity is consolidated through accounting guidance other than VIE guidance.

810-10-15-17C If any of the conditions in paragraph 810-10-15-17A for applying the accounting alternative cease to be met, a private company shall apply the guidance in the Variable Interest Entities Subsections at the date of change on a prospective basis.

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

Recognition

Variable Interest Entities

> > Implicit Variable Interests

810-10-25-48 Paragraph superseded by Accounting Standards Update 2014-07. Implicit variable interests commonly arise in leasing arrangements among related

~~parties, and in other types of arrangements involving related parties and unrelated parties.~~

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

810-10-25-54 The reporting entity shall consider whether it holds an implicit variable interest in the VIE or potential VIE. The determination of whether an implicit variable interest exists shall be based on all facts and circumstances in determining whether the reporting entity may absorb variability of the VIE or potential VIE. A reporting entity that holds an implicit variable interest in a VIE and is a related party to other variable interest holders shall apply the guidance in paragraph 810-10-25-44 to determine whether it is the primary beneficiary of the VIE. That is, if the aggregate variable interests held by the reporting entity (both implicit and explicit variable interests) and its related parties would, if held by a single party, identify that party as the primary beneficiary, then the party within the related party group that is most closely associated with the VIE is the primary beneficiary. The guidance in paragraphs ~~810-10-25-48~~810-10-25-49 through 25-54 applies to related parties as defined in paragraph 810-10-25-43. For example, the guidance in paragraphs ~~810-10-25-48~~810-10-25-49 through 25-54 applies to any of the following situations:

- a. A reporting entity and a VIE are under common control.
- b. A reporting entity has an interest in, or other involvement with, a VIE and an officer of that reporting entity has a variable interest in the same VIE.
- c. A reporting entity enters into a contractual arrangement with an unrelated third party that has a variable interest in a VIE and that arrangement establishes a related party relationship.

5. Add paragraphs 810-10-50-2AD through 50-2AF and their related heading and amend paragraph 810-10-50-5A(d), with a link to transition paragraph 810-10-65-4, as follows:

Disclosure

Variable Interest Entities

> Accounting Alternative

810-10-50-2AD A private company lessee that does not apply the requirements of the Variable Interest Entities Subsections to one or more lessor legal entities because it meets the criteria in paragraph 810-10-15-17A 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 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.

810-10-50-2AF In disclosing information about the lessor legal entity, a private company lessee shall present the disclosures in combination with the disclosures required by other guidance (for example, in Topics 460 on guarantees, 850 on related party disclosures, and 840 on leases). Those disclosures could be combined in a single note or by including cross-references within the notes to financial statements.

> Primary Beneficiaries or Other Holders of Interests in VIEs

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

- d. Qualitative and quantitative information about the reporting entity's involvement (giving consideration to both explicit arrangements and implicit variable interests) with the VIE, including, but not limited to, the nature, purpose, size, and activities of the VIE, including how the VIE is financed. Paragraphs ~~810-10-25-48~~ 810-10-25-49 through 25-54 and Example 4 (see paragraph ~~810-10-55-87~~) provide guidance on how to determine whether a reporting entity has an implicit variable interest in a VIE.
6. Add paragraphs 810-10-55-9 and its related heading and 810-10-55-205A through 55-205I and their related headings and supersede paragraphs 810-10-55-87 through 55-89 and their related heading, with a link to transition paragraph 810-10-65-4, as follows:

Implementation Guidance and Illustrations

Variable Interest Entities

> Implementation Guidance

> > Accounting Alternative

810-10-55-9 ~~Paragraph not used.~~ In applying the guidance in paragraph 810-10-15-17A, the following are examples of activities that are considered to be leasing activities (including supporting leasing activities) between a private company lessee and a lessor **legal entity**:

- a. A guarantee or collateral provided by the **private company** lessee to the lender of a lessor legal entity under common control for indebtedness that is secured by the asset(s) leased by the private company lessee
- b. A joint and several liability arrangement for indebtedness of the lessor legal entity, for which the private company lessee is one of the obligors, that is secured by the asset(s) leased by the private company lessee
- c. Paying property taxes, negotiating the financing, and maintaining the asset(s) leased by the private company lessee
- d. Paying income taxes of the lessor legal entity when the only asset owned by the lessor legal entity is being leased either by only the

private company or by both the private company lessee and an unrelated party.

Paying income taxes of the lessor legal entity on income generated by an asset that is not being leased by the private company lessee is not considered to be a leasing activity between the private company lessee and the lessor legal entity. A purchase commitment (other than for the acquisition of or the support of the leased asset) is not considered to be related to the leasing activity between the private company lessee and the lessor legal entity.

> Illustrations

>> Example 4: Implicit Variable Interests

810-10-55-87 Paragraph superseded by Accounting Standards Update 2014-07. This Example illustrates the guidance in paragraphs 810-10-25-48 through 25-54.

810-10-55-88 Paragraph superseded by Accounting Standards Update 2014-07. One of the two owners of Manufacturing Entity is also the sole owner of Leasing Entity, which is a VIE. The owner of Leasing Entity provides a guarantee of Leasing Entity's debt as required by the lender. Leasing Entity owns no assets other than the manufacturing facility being leased to Manufacturing Entity. The lease, with market terms, contains no explicit guarantees of the residual value of the real estate or purchase options and is therefore not considered a variable interest under paragraph 810-10-55-39. The lease meets the classification requirements for an operating lease and is the only contractual relationship between Manufacturing Entity and Leasing Entity.

810-10-55-89 Paragraph superseded by Accounting Standards Update 2014-07. Manufacturing Entity should consider whether it holds an implicit variable interest in Leasing Entity. Although the lease agreement itself does not contain a contractual guarantee, Manufacturing Entity should consider whether it holds an implicit variable interest in Leasing Entity as a result of the leasing arrangement and the relationship between it and the owner of Leasing Entity. For example, Manufacturing Entity would be considered to hold an implicit variable interest in Leasing Entity if Manufacturing Entity effectively guaranteed the owner's investment in Leasing Entity. The guidance in paragraphs 810-10-25-48 through 25-54 shall be used only to evaluate whether a variable interest exists under the Variable Interest Entities Subsections and shall not be used in the evaluation of lease classification in accordance with Topic 840. Paragraph 840-10-25-26 addresses leases between related parties. Manufacturing Entity may be expected to make funds available to Leasing Entity to prevent the owner's guarantee of Leasing Entity's debt from being called on, or Manufacturing Entity may be expected to make funds available to the owner to fund all or a portion of

~~the call on Leasing Entity's debt guarantee. The determination as to whether Manufacturing Entity is effectively guaranteeing all or a portion of the owner's investment or would be expected to make funds available and, therefore, an implicit variable interest exists, shall take into consideration all the relevant facts and circumstances. Those facts and circumstances include, but are not limited to, whether there is an economic incentive for Manufacturing Entity to act as a guarantor or to make funds available, whether such actions have happened in similar situations in the past, and whether Manufacturing Entity acting as a guarantor or making funds available would be considered a conflict of interest or illegal.~~

> > Accounting Alternative

> > > Private Company Accounting Alternative for Leasing Arrangements under Common Control

810-10-55-205A The following Examples illustrate the application of the guidance in paragraph 810-10-15-17A on determining whether a reporting entity that is a private company can elect the accounting alternative not to apply VIE guidance to a legal entity under common control:

- a. Common control leasing arrangement with no leasing or other activities with unrelated parties (Example 6)
- b. Common control leasing arrangement with additional leasing activities with unrelated parties (Example 7)
- c. Common control leasing arrangement with additional activities other than leasing or for the support of leasing (Example 8).

810-10-55-205B Examples 6 through 8 share all of the following assumptions:

- a. The sole owner of Manufacturing Entity (a private company) is also the sole owner of Lessor Entity.
- b. Manufacturing Entity has pledged its assets as collateral for Lessor Entity's mortgage.
- c. The common owner of both entities has provided a guarantee of Lessor Entity's mortgage as required by the lender.
- d. Manufacturing Entity leases its manufacturing facility from Lessor Entity.
- e. The value of the manufacturing facility leased by Manufacturing Entity exceeds the principal amount of Lessor Entity's mortgage at inception of the mortgage.
- f. Manufacturing Entity has elected to apply the accounting alternative described in paragraph 810-10-15-17A.

> > > Example 6: Common Control Leasing Arrangement with No Leasing or Other Activities with Unrelated Parties

810-10-55-205C Lessor Entity owns no assets other than the manufacturing facility being leased to Manufacturing Entity. Manufacturing Entity pays property taxes on behalf of Lessor Entity and maintains the manufacturing facility. Therefore, Manufacturing Entity meets all four criteria in paragraph 810-10-15-17A and, as a result of its elected accounting policy, would apply the accounting alternative to Lessor Entity based on the following:

- a. Manufacturing Entity and Lessor Entity are under common control.
- b. Manufacturing Entity has a lease arrangement with Lessor Entity.
- c. Substantially all the activities between Manufacturing Entity and Lessor Entity are related to the lease of the manufacturing facility to Manufacturing Entity. Providing collateral, paying property taxes, and maintaining the manufacturing facility are considered to be leasing activities between Manufacturing Entity and Lessor Entity as described in paragraph 810-10-55-9.
- d. The value of the manufacturing facility leased by Manufacturing Entity exceeds the principal amount of Lessor Entity's mortgage at inception of the mortgage.

810-10-55-205D If in two years the value of the manufacturing facility declines below the principal amount of the mortgage, Manufacturing Entity would continue to apply this accounting alternative (assuming no other changes have occurred) because the manufacturing facility met criterion (d) in paragraph 810-10-15-17A at inception of the arrangement.

810-10-55-205E If Lessor Entity refinances or enters into a new obligation that requires collateralization or a guarantee by Manufacturing Entity, then Manufacturing Entity would be required to reassess whether criterion (d) in paragraph 810-10-15-17A is met at the inception of the new obligation. For example, if Lessor Entity refinances the mortgage (collateralized by assets of Manufacturing Entity) and the new principal balance of the mortgage exceeds the value of the manufacturing facility, then the arrangement would no longer meet criterion (d). Not meeting the criteria to qualify for the accounting alternative does not automatically result in consolidation. Instead, Lessor Entity will need to be evaluated under this Topic, including VIE guidance, for consolidation and related disclosure requirements.

> > > Example 7: Common Control Leasing Arrangement with Additional Leasing Activities with Unrelated Parties

810-10-55-205F Manufacturing Entity leases 3 of the 10 floors of the manufacturing facility from Lessor Entity. Lessor Entity leases the remaining seven floors of the same manufacturing facility to unrelated parties. Manufacturing Entity continues to pledge its assets as collateral for the mortgage that financed the purchase of the entire manufacturing facility (that is, all 10

floors). In this Example, Manufacturing Entity meets all four criteria in paragraph 810-15-17A and, as a result of its elected accounting policy, would apply the accounting alternative to Lessor Entity based on the following:

- a. Manufacturing Entity and Lessor Entity are under common control.
- b. Manufacturing Entity has a lease arrangement with Lessor Entity.
- c. Substantially all the activities between Manufacturing Entity and Lessor Entity are related to the lease of the manufacturing facility to Manufacturing Entity, even though part of the manufacturing facility is also leased to unrelated parties.
- d. The value of the manufacturing facility leased by Manufacturing Entity exceeds the principal amount of Lessor Entity's mortgage at inception of the mortgage.

810-10-55-205G Subsequently, Lessor Entity purchases an additional facility that is leased only to unrelated parties. The value of the new facility is significant to Lessor Entity, and the mortgage on the additional facility requires a guarantee by Manufacturing Entity. Under these circumstances, Manufacturing Entity failed to meet criterion (c) in paragraph 810-10-15-17A to qualify for the accounting alternative when the guarantee is executed and leasing activity with unrelated parties commenced. Manufacturing Entity is engaging in substantial activity outside its leasing activity with Lessor Entity by providing a guarantee on a mortgage secured by an asset that is not being leased by Manufacturing Entity. Not meeting the criteria to qualify for the accounting alternative does not automatically result in consolidation. Instead, Lessor Entity will need to be evaluated under this Topic, including VIE guidance, for consolidation and related disclosure requirements.

> > > Example 8: Common Control Leasing Arrangement with Additional Activities Other Than Leasing or for the Support of Leasing

810-10-55-205H Lessor Entity manufactures cosmetics products in another facility that is unrelated to the operations of Manufacturing Entity. There is no mortgage associated with this additional facility, and Manufacturing Entity does not provide collateral or guarantee any obligations related to the cosmetics business. In this Example, Manufacturing Entity meets all four criteria in paragraph 810-10-15-17A and, as a result of its elected accounting policy, would apply the accounting alternative to Lessor Entity based on the following:

- a. Manufacturing Entity and Lessor Entity are under common control.
- b. Manufacturing Entity has a lease arrangement with Lessor Entity.
- c. Substantially all the activities between Manufacturing Entity and Lessor Entity are related to the lease of the manufacturing facility to Manufacturing Entity.

- d. The value of the manufacturing facility leased by Manufacturing Entity exceeds the principal amount of Lessor Entity's mortgage at inception of the mortgage. There is no obligation associated with the purchase of the cosmetic facility.

810-10-55-205I If there is a mortgage on Lessor Entity's cosmetics facility that requires Manufacturing Entity to provide collateral and/or a guarantee, then Manufacturing Entity may not apply this accounting alternative to the Lessor Entity because it would not meet criterion (c) in paragraph 810-10-15-17A. A purchase of cosmetics from Lessor Entity by Manufacturing Entity also would require an evaluation of whether criterion (c) of paragraph 810-10-15-17A is met. Not meeting the criteria to qualify for the accounting alternative does not automatically result in consolidation. Instead, Lessor Entity will need to be evaluated under this Topic, including VIE guidance, for consolidation and related disclosure requirements.

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

> Transition Related to Accounting Standards Update No. 2014-07, Consolidation (Topic 810): Applying Variable Interest Entities Guidance to Common Control Leasing Arrangements

810-10-65-4 The following represents the transition and effective date information related to Accounting Standards Update No. 2014-07, Consolidation (Topic 810): Applying Variable Interest Entities Guidance to Common Control Leasing Arrangements:

- a. The pending content that links to this paragraph shall be effective for the first annual period beginning after December 15, 2014, and interim periods within annual periods beginning after December 15, 2015.
- b. Early application is permitted for any annual or interim period before which an entity's **financial statements are available to be issued**.
- c. The pending content that links to this paragraph shall be applied retrospectively to all periods presented.
- d. If a reporting entity deconsolidates a variable interest entity (VIE) as a result of the application of the pending content that links to this paragraph, the reporting entity shall initially measure any retained interest in the deconsolidated VIE at its carrying amount at the date the pending content that links to this paragraph first applies. In this context, *carrying amount* refers to the amount at which any retained interest would have been carried in the reporting entity's financial statements if the pending content that links to this paragraph had been effective when the reporting entity became involved with the VIE. Any difference between the net amount removed from the statement of financial position of the reporting entity and the amount of any retained interest in

- the 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.
- e. An entity shall provide the disclosures in paragraphs 250-10-50-1 through 50-3 except for the disclosure in paragraph 250-10-50-1(b)(2) in the period the entity adopts the pending content that links to this paragraph.

Amendments to Subtopic 840-10

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

Leases—Overall

Relationships

General

> Consolidation

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

Amendments to Status Sections

9. Amend paragraph 810-10-00-1, by adding the following items to the table, as follows:

810-10-00-1 The following table identifies the changes made to this Subtopic.

Paragraph Number	Action	Accounting Standards Update	Date
Financial Statements Are Available to Be Issued	Added	2014-07	03/20/2014

Paragraph Number	Action	Accounting Standards Update	Date
Private Company	Added	2014-07	03/20/2014
Public Business Entity	Added	2014-07	03/20/2014
810-10-15-17A through 15-17C	Added	2014-07	03/20/2014
810-10-25-48	Superseded	2014-07	03/20/2014
810-10-25-52	Amended	2014-07	03/20/2014
810-10-25-54	Amended	2014-07	03/20/2014
810-10-50-2AD through 50-2AF	Added	2014-07	03/20/2014
810-10-50-5A	Amended	2014-07	03/20/2014
810-10-55-9	Added	2014-07	03/20/2014
810-10-55-87 through 55-89	Superseded	2014-07	03/20/2014
810-10-55-205A through 55-205I	Added	2014-07	03/20/2014
810-10-65-4	Added	2014-07	03/20/2014

10. Amend paragraph 840-10-00-1, by adding the following item to the table, as follows:

840-10-00-1 The following table identifies the changes made to this Subtopic.

Paragraph Number	Action	Accounting Standards Update	Date
840-10-60-4	Amended	2014-07	03/20/2014

The amendments in this Update were endorsed by the unanimous vote of the seven members of the Financial Accounting Standards Board:

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

Background Information and Basis for Conclusions

Introduction

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

BC2. On the basis of input received through outreach with users, preparers, and public accountants of private company financial statements and feedback received in various other forums, the PCC decided to add to its agenda a project that explored potential alternatives for applying VIE guidance to common control lessor entities. On August 22, 2013, the FASB issued an Exposure Draft on decisions reached by the PCC to provide an elective accounting alternative for private companies in applying VIE guidance to lessor entities under common control. The Board received 41 comment letters on the Exposure Draft. Overall, many respondents to the Exposure Draft supported the proposal. However, in response to feedback received, the PCC made some modifications to the proposed accounting alternative for applying VIE guidance to common control lessor entities. Those modifications and the reasons for them are discussed throughout this basis for conclusions.

BC3. The amendments allow a private company lessee (reporting entity) to elect an alternative not to apply VIE guidance to the lessor entity if (a) the private company lessee and the lessor entity are under common control, (b) the private company lessee has a leasing arrangement with the lessor entity, (c) substantially all of the activities between the private company lessee and the lessor entity are related to the leasing activities (including supporting leasing activities) between those two entities, and (d) if the private company lessee explicitly guarantees or provides collateral for any obligation of the lessor entity related to the asset leased by the private company, then the principal amount of the obligation at inception of such guarantee or collateral arrangement does not exceed the value of the asset leased by the private company from the lessor entity.

Scope

BC4. The Board and the PCC decided that the scope of this Update should be consistent with the scope of the *Private Company Decision-Making Framework: A Guide for Evaluating Financial Accounting and Reporting for Private Companies* (Guide). Therefore, the amendments under the heading “Accounting Alternative” will apply to all entities other than a public business entity, a not-for-profit entity, or an employee benefit plan within the scope of Topics 960 through 965 on plan accounting.

BC5. The Board concluded that the accounting alternative should not be extended to public business entities and employee benefit plans because the arrangements that this accounting alternative addresses are much more prevalent in the context of private companies. Not-for-profit entities already are excluded substantially from the scope of VIE guidance.

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

Background Information

BC7. U.S. GAAP requires a reporting entity to consolidate an entity in which it has a controlling financial interest. There are two primary models for assessing whether there is a controlling financial interest: the voting interest model and the VIE model. Under the voting interest model, a controlling financial interest generally is obtained through ownership of a majority of an entity's voting interests. Under the VIE model, a reporting entity is deemed to have a controlling financial interest (that is, deemed to be the primary beneficiary) when it has both (a) the power to direct the activities that most significantly affect the economic performance of the entity and (b) the obligation to absorb losses or the right to receive benefits of the entity that could potentially be significant to the entity. To determine which model applies, a reporting entity must determine whether it has a variable interest and whether the entity being evaluated is a VIE.

BC8. Before the amendments in the Update, Topic 810 (paragraphs 810-10-55-87 through 55-89) contained an example derived from FSP FIN 46(R)-5 (FSP example). In the FSP example, a reporting entity (lessee entity) leases a facility from a leasing entity (lessor entity) that is owned by one of the reporting entity's two owners and has the facility as its only asset. The operating lease, with market terms, is the only contractual relationship between the two entities. Furthermore, the lease contains no other explicit arrangements, such as a guarantee of the residual value or a purchase option of the leased asset. U.S. GAAP requires the lessee entity in such circumstances to consider whether it holds an implicit variable interest, for example, a guarantee of the lessor's debt. If

a lessee entity holds a variable interest (explicit or implicit) in the lessor entity and determines that the lessor entity is a VIE, then the lessee entity must assess whether it holds a controlling financial interest in the lessor entity. As a result, a lessee entity, in certain circumstances, may be required to consolidate a lessor entity when they both are under common control.

BC9. The PCC added this Issue to its agenda in response to feedback from private company stakeholders through various channels including (a) the nonpublic entity roundtables, (b) written submissions to the Blue-Ribbon Panel on Standard Setting for Private Companies and the Financial Accounting Foundation's Plan to Establish the Private Company Standards Improvement Council, and (c) the Private Company Financial Reporting Committee. Many private company stakeholders indicated that consolidation should be a high hurdle. In other words, unless it is clearly evident that an entity's rights provide the entity with the ability to control another entity, users of private company financial statements typically do not support consolidation. Most private company stakeholders state that VIE guidance is unduly complex and costly to apply. Furthermore, many private company stakeholders state that VIE guidance is difficult to follow.

BC10. While the feedback on VIE guidance was broad, most private company stakeholders focused on applying VIE guidance to lessor entities under common control with the reporting lessee entity. The most typical example cited is one that is similar to the FSP example discussed in paragraph BC8 or is some variation of the FSP example. Private company stakeholders stated that, generally, a common owner establishes a lessor entity separate from the private company lessee for tax, estate-planning, and legal-liability purposes—not to structure off-balance-sheet debt arrangements. In instances in which a lessor entity is consolidated by a private company lessee entity on the basis of VIE guidance, most users of the private company lessee entity's financial statements stated that consolidation is not relevant to them because they focus on the cash flows and tangible worth of the standalone private company lessee entity, rather than on the consolidated cash flows and tangible worth of the private company lessee entity as presented under U.S. GAAP. Those users also stated that consolidation of the lessor entity under common control distorts financial statements of the private company lessee entity because the assets held by the lessor entity would not be available to satisfy the obligations of the lessee entity. They indicated that these assets are beyond the reach of the lessee's creditors, even in bankruptcy or other receivership. Consequently, those users stated that when they receive consolidated financial statements, they often request a consolidating schedule to enable them to reverse the effects of consolidating the lessor entity.

BC11. Some users of private company financial statements, such as sureties, stated that consolidation of lessor entities under common control provides decision-useful information. However, sureties expressed the most interest in knowing about the terms of the borrowing entered into by the lessor; this is especially true when the performance of a bonded project relies on collateralized

equipment or property held by the lessor. Some sureties also stated that robust disclosures about the terms of the borrowings of the lessor could be sufficient in instances in which the lessor entity is not consolidated.

Criteria to Qualify for the Accounting Alternative

BC12. On the basis of input from private company stakeholders, the PCC reached a consensus to provide an alternative that addresses the concerns about applying VIE guidance to lessor entities under common control. The PCC concluded that the alternative method, if elected, will reduce the cost and complexity of preparing financial statements while continuing to provide decision-useful information to users of private company financial statements. For those users who find relevance in lessee entities consolidating lessor entities under common control, the PCC concluded that the disclosures under this alternative provide the necessary information without the cost and complexity of applying VIE guidance.

BC13. Criterion (a) of paragraph 810-10-15-17A requires that the private company lessee and the lessor entity be under *common control*. While most stakeholders agreed with criterion (a), several stakeholders voiced concerns that common control is not defined in the *FASB Accounting Standards Codification*[®]. Public business entities currently look to the U.S. Securities & Exchange Commission (SEC) observations¹ documented in EITF Issue No. 02-5, “Definition of ‘Common Control’ in Relation to FASB Statement No. 141,” to determine common control, but there was never a final consensus reached by the Task Force on this EITF Issue.

BC14. The PCC acknowledged the concerns raised by stakeholders, but decided not to define common control. The PCC noted that the term common control currently exists in other areas of U.S. GAAP (for example, Topic 805, Business Combinations). Establishing a definition for common control would be a

¹. . . the SEC staff has indicated that common control exists between (or among) separate entities only in the following situations:

- a. An individual or enterprise holds more than 50 percent of the voting ownership interest of each entity.
- b. Immediate family members hold more than 50 percent of the voting ownership interest of each entity (with no evidence that those family members will vote their shares in any way other than in concert).
 - (1) Immediate family members include a married couple and their children, but not the married couple’s grandchildren.
 - (2) Entities might be owned in varying combinations among living siblings and their children. Those situations would require careful consideration regarding the substance of the ownership and voting relationships.
- c. A group of shareholders holds more than 50 percent of the voting ownership interest of each entity, and contemporaneous written evidence of an agreement to vote a majority of the entities’ shares in concert exists. [paragraph 3 of Issue 02-5]

change that could affect all entities including public business entities and, therefore, was outside the scope of this PCC Issue. Furthermore, establishing a definition of common control would require further analysis, which could have delayed significantly the issuance of this Update.

BC15. For the purposes of applying this accounting alternative, the Board and the PCC concluded that common control is broader than the notion provided by the SEC observations on EITF Issue 02-5. For example, an entity owned by a grandparent and an entity owned by a grandchild could, on the basis of facts and circumstances, be considered as entities under common control for the purposes of applying this accounting alternative. Because common control is not an entirely new concept within U.S. GAAP, stakeholders in current practice should be able to assess whether common control exists.

BC16. The PCC decided to restrict the accounting alternative to arrangements in which substantially all of the activity between the two entities is related to the leasing activity between the lessor entity and the private company lessee. The PCC concluded that this criterion is effective in mitigating structuring opportunities while still addressing the concerns about applying VIE guidance to lessor entities under common control.

BC17. During redeliberations, the PCC considered that, generally, a greater level of activity by the lessor entity unrelated to the private company lessee would decrease the likelihood of consolidation under the VIE model. As such, the PCC decided that the alternative should permit the lessor entity to conduct activities other than leasing to the private company lessee as long as those activities are unrelated to the private company lessee. The PCC wanted to prevent private companies from performing a comprehensive VIE analysis in situations that likely would result in no consolidation.

BC18. The PCC also added criterion (d) in paragraph 810-10-15-17A, which requires that if the private company explicitly guarantees or provides collateral for any obligation of the lessor entity related to the asset leased by the private company, then the principal amount of the obligation at inception of such guarantee or collateral arrangement does not exceed the value of the asset leased by the private company from the lessor entity. Criterion (d) was added to mitigate off-balance-sheet structuring opportunities. Without criterion (d), an entity could exclude a highly leveraged lessor entity that has a nominal leasing arrangement with a private company lessee from a consolidation assessment under the VIE model. The PCC decided that criterion (d) should be assessed only at the inception of a guarantee or collateral arrangement. The purpose of the *at inception* language is to prevent a private company lessee from continually reassessing whether a value of a leased asset continues to exceed the principal amount of obligations that are guaranteed or collateralized by a private company lessee when the only change is due to the change in value of the leased asset. For example, a subsequent decline in the value of a leased asset below the principal amount of a corresponding mortgage held by a lessor entity would not

cause a private company to fail criterion (d) as long as criterion (d) was met at inception of the arrangement. However, if the lessor entity subsequently refinances or enters into any new obligation or obligations that require collateralization and/or a guarantee by the private company lessee, then the private company lessee would be required to reassess whether criterion (d) is met at the inception of the new arrangement(s).

Other Alternatives Considered

BC19. The PCC considered two other alternatives for addressing the concerns of applying VIE guidance to leasing arrangements under common control. The first alternative was to provide more guidance on the identification of variable interests (variable interest alternative). The variable interest alternative would have modified the FSP example in the implementation guidance discussed in paragraph BC8 by clarifying that a variable interest, such as an implied guarantee on the lessor entity's debt, does not exist. The basis for that conclusion is that a variable interest should absorb variability that is created by a legal entity and passed along to its interest holders. The modified example would have stressed that the implied guarantee would not be considered a variable interest because an implied guarantee on the lessor entity's debt primarily absorbs the risk created by the lessee entity itself not making its required lease payments and, therefore, does not represent variability that is created by the legal entity and is passed through to the interest of the lessee entity.

BC20. The PCC decided against the variable interest alternative because that alternative does not address explicit variable interests (for example, guarantees and collateral arrangements) relating to the lessor entity's obligations. The PCC was concerned that explicit interests related to leasing arrangements under common control could still result in consolidation under VIE guidance. Some members of the PCC also were concerned about the possibility of unintended consequences as a result of modifying the implicit variable interest guidance. Furthermore, the PCC received feedback that the variable interest alternative, as compared with current U.S. GAAP, still would require private companies to apply costly and complex VIE guidance to lessor entities under common control. However, these cost concerns may be overstated given that the variable interest alternative would focus on the first step of the VIE model by making it clear, in most circumstances addressed by this Update, that absent explicit guarantees or collateralization of lessor entity's debt, the lessee would not have a variable interest in the lessor and, therefore, would not need to apply the VIE model.

BC21. Another alternative considered by the PCC was to clarify the primary beneficiary assessment by leveraging the example discussed in paragraph BC8 and adding implementation guidance on how to identify the primary beneficiary (primary beneficiary alternative). That implementation guidance would have provided a detailed example in which a lessee entity would not have the power to direct the activities that most significantly affect a lessor entity under common control and, as a result, would not require consolidation of the lessor entity.

BC22. The PCC decided against the primary beneficiary alternative because it focuses on the last step of the VIE model. The PCC concluded that this alternative would not address the cost and complexity of applying VIE guidance to leasing arrangements under common control.

Removal of the FSP Example

BC23. The Board decided to eliminate the FSP example that is codified in paragraphs 810-10-55-87 through 55-89. The Board concluded that the accounting alternative in this Update contradicts the FSP example because it exempts private companies with a fact pattern similar to the FSP example from applying VIE guidance. In addition, some stakeholders stated that the FSP example does not result in the lessee entity holding an implicit variable interest in the form of a guarantee on the lessor entity's debt. Those stakeholders agree with the basis that supports the alternative discussed in paragraph BC19.

BC24. Although the Board decided to remove the FSP example, the Board concluded that the FSP example primarily was applied by private companies and that its removal is not expected to have a significant effect on public business entity and employee benefit plan stakeholders. The removal of the FSP example also would not affect not-for-profit entities because not-for-profit entities already are excluded substantially from the scope of VIE guidance.

Disclosure

BC25. To the extent a lessor entity under common control is not consolidated, Topic 840 on leases already requires a private company lessee to disclose current-period rent expense charged by the lessor entity and future committed lease payments based on a lease agreement. In addition, the lessee entity is required to provide other applicable disclosures in U.S. GAAP, including those required by Topic 460 on guarantees.

BC26. In applying this alternative, the PCC decided that a private company lessee would not be required to provide VIE disclosures about the lessor entity. Rather, the private company lessee would disclose (a) the amount and key terms of liabilities recognized by the lessor entity that expose the private company lessee to providing financial support to the lessor entity and (b) a qualitative description of circumstances not recognized in the financial statements of the lessor entity that expose the private company lessee to providing financial support to the lessor entity. The disclosures under this alternative are required in combination with the disclosure required by other Topics (for example, Topics 460, 840, and 850) about the lessee entity's relationship with the lessor entity. The disclosures could be combined into a single note or could include cross-references within the notes to the financial statements.

BC27. While most users of private company financial statements stated that consolidation of lessor entities under common control does not provide decision-useful information, the PCC recognizes that some users, such as sureties,

disagree. The PCC believes that the combined disclosures required in this Update and other Topics about the nonconsolidated lessor entity serve the information needs of sureties. Furthermore, the PCC believes that the combined disclosure requirements under this accounting alternative will deter the use of lessor entities from structuring off-balance-sheet arrangements for financial reporting purposes.

BC28. The PCC also considered access to management in developing an alternative to address the concerns about applying VIE guidance to lessor entities under common control. The Board and the PCC concluded that this Update provides sufficient quantitative and qualitative disclosure in the notes necessary to facilitate a user's review and to allow a user to identify appropriate follow-up questions to management when the user deems it necessary to do so (the red-flag approach to disclosure).

Transition

BC29. The PCC decided that a private company should apply the alternative, if elected, retrospectively to all periods presented. The PCC concluded that the benefit of consistent consolidated financial information between reporting periods justifies the cost and complexity of applying a full retrospective approach.

BC30. The PCC does not believe that retrospective application of the amendments in this Update will be burdensome or costly. Feedback from users indicated that they often request consolidating schedules when a lessee entity consolidates a lessor entity. Those schedules could be used by preparers to apply the amendments in this Update retrospectively.

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

BC31. The objective of financial reporting is to provide information that is useful to present and potential investors, creditors, and other capital market participants in making rational investment, credit, and similar resource allocation decisions. However, the benefits of providing information for that purpose should justify the related costs. The Guide provides considerations for the Board and the PCC in making user-relevance and cost-benefit evaluations for private companies under the existing conceptual framework. The Guide is a tool to help the Board and the PCC to identify differential information needs of users of public company financial statements and users of private company financial statements and to identify opportunities to reduce the relatively greater cost and complexity of preparing financial statements for private companies in accordance with U.S. GAAP. The Board and the PCC's assessment of the costs and benefits of issuing new guidance is unavoidably more qualitative than quantitative because there is no method to objectively measure the costs to implement new guidance or to quantify the value of improved information in financial statements.

BC32. Most users of private company financial statements state that the consolidation of lessor entities under common control distorts financial statements of lessee entities. For those users who find relevance in consolidating lessor entities under common control, the PCC concluded that the disclosures under this accounting alternative provide the information desired.

BC33. The Board and the PCC concluded that the accounting alternative, when elected, will improve or maintain decision-useful information for the users of private company financial statements while reducing the cost and complexity associated with applying VIE guidance to lessor entities under common control. Therefore, the Board and the PCC concluded that this Update meets the overall objective of the Guide for addressing the needs of private company stakeholders.