TX Office: (817) 416-6842
NV Office: (702) 565-2727

Kral Ussery LLC
Certified Public Accountants
Advisors - Litigation Support - Internal Audit

September 23, 2020

VIEs Simplified

A few simple questions to identify a variable interest and possibly eliminate the applicability of the VIE consolidation model

By Michael Ussery, CPA
Partner, Kral Ussery LLC

One of the most complicated topics in US accounting is variable interest entities, or VIEs. Even the name conjures up images of flow charts explaining complicated ownership chains of mysterious paper companies. Seriously FASB, couldn't you have come up with a better name?

The VIE model comes into play only in consolidation. An organization, let's call it a parent company, is required to consolidate another legal entity when it has a *controlling financial interest.* In most situations, ownership of a majority of the voting equity of a legal entity, say 51%, gives the parent company this required *controlling financial interest.* The underlying assumption is that when a parent company owns a majority of a legal entity, they control the legal entity either directly by managing it or indirectly through voting power. In a typical parent company-subsidiary relationship, the parent company would consolidate the subsidiary under what is generally referred to as the Voting Interest model.

However, application of the Voting Interest model does not always give the correct result. For example, assume two unrelated entities form Company Z to manufacture a product. Investor A owns 75% of the equity. Investor B has manufacturing experience and owns the remaining 25% of the equity. Each Investor is entitled to vote according to their ownership percentage. The equity is sufficient to fund the operations of Company Z. However, Investor B is hired as the operations manager and cannot be removed (except for cause), makes all of the operational and strategic decisions and is compensated at 60% of the operating profit of Company Z. In this scenario, Investor A (the 75% owner) and Investor B (the 25% owner) have little control over Company Z through their equity ownership. However, it appears that Investor B has the *controlling financial interest*, through the management contract, even though that entity has only a 25% equity interest in Company Z. Application of the Voting Interest model would not work in this scenario.

Hence the need exists for another model for determining when an organization has a *controlling financial interest.* While the application and special nuances of the VIE model are complicated, the end result of the model is quite simple: Does a parent company consolidate an entity or not? With the exception of additional disclosure and presentation rules, there are no special consolidation rules applicable to the VIE model. Consolidation under the VIE model and the Voting Interest model are nearly identical.

When to determine if the VIE model is applicable?

Every time. Anytime a company has a variable interest in another legal entity, especially a subsidiary, the VIE model should be considered, even before the Voting Interest model. The VIE model should be eliminated (or applied) before all other accounting treatment is considered. The good news is that about 90-95% of the time, the VIE model is scoped out or is not applicable. The bad news is that VIE indicators are frequently overlooked and therefore, the assessment of whether the VIE model is applicable is never properly made.

Oftentimes the identification of VIE indicators and a consideration of the more common exemptions can be used to quickly eliminate the applicability of the VIE model to consolidation considerations for an entity. Using the KISS (keep it simple, Simon) principle, we have developed a series of questions that will help identify VIE indicators and will assist in eliminating the applicability of the VIE model using the more common exceptions. The questions do not address every situation or exemption. If, after addressing the questions below, the VIE model is still applicable to your situation, further analysis will be required.

Does your company have a variable interest in another entity?

A variable interest is a financial interest that absorbs losses or benefits from risks of an entity. Risks of an entity are viewed from an entity wide perspective. Equity is the most common form of variable interest. Equity interests generally benefit through higher value as the net assets of the legal entity increase in value or it earns profits. Equity interests generally lose value as the net assets decrease in value or the legal entity post losses (absorb losses). Virtually all debt is a variable interest because debt holders may lose money (absorb losses) if the legal entity cannot pay back its borrowings. Certain types of financial interest that absorb risks are variable interest in some circumstances and not in others. For example, a lease with a fixed purchase option generally gives the lessee the option to benefit from increases in value of the underlying asset. If the leased asset was the legal entity's only or major asset, the lease may be considered a variable interest in the legal entity. If the leased asset was not a major asset of the legal entity, then it would generally not be a variable interest in the legal entity.

The following instruments may contain variable interests (not all inclusive):

- An equity interest
- Management contract (see example above)
- A debt instrument
- A beneficial interest
- A lease, including residual value guarantees (generally only applicable if the leased asset represents greater than 50% of the FV of the legal entity's assets)
- A derivative
- Cost plus arrangements
- A guarantee
- Service contracts

Any company that has a variable interest in another legal entity must consider whether the VIE consolidation model is applicable. Since equity is not the only form of variable interests, it is possible under the VIE model for a company to consolidate a legal entity in which it has no equity. Proceed to the next question.

Is your company a private company?

If your company is a private company (as defined in ASC 810-10-20), your company may elect to be exempted from the application of the VIE consolidation model under certain circumstances. This election is effective for years beginning after December 15, 2020, or earlier if adopted early. This is an optional election and has a number of restrictions, as follows:

1. Is the parent company and the legal entity being evaluated for consolidation under common control under the Voting Interest model?
2. Are the parent company, the legal entity and the common control parent private companies, as defined in ASC 810-10-20?
3. Does the parent company directly or indirectly lack the ability to control the legal entity under the Voting Interest model?

If you answer “No” to any of the above questions, your company is NOT eligible for this election. Proceed to the next question.

All of our subsidiaries are traditional operating entities. Can I automatically eliminate the VIE model?

No, no and no. While business (as defined by the new business standard) are scoped out generally, there are four exceptions to the general rule, known as the ‘business scope exemption’:

1. Did the parent company, related parties, or both participate significantly in the design (or redesign) of the legal entity? Joint ventures and franchisees are exempted from this criterion.
2. Is substantially all of the legal entity’s operations conducted on behalf of the parent company and its related parties?
3. Did the parent company and its related parties contribute more than half of the equity debt or other support (based on fair value)?
4. Are the activities primarily related to securitizations, other forms of asset-backed financing or single-lessee leasing arrangements?

If you answered yes to ANY one of the 4 criteria, consider whether the VIE consolidation model is applicable. Proceed to the next question.

Is the entity a variable interest entity (VIE)?

This is where the rubber meets the road and where many entities scope out of the VIE model. Admittedly, most holders of variable interest may be able to skip right to this step and easily determine that the legal entity is not a VIE. VIE analysis done. Happy hour anyone?

Determination of whether or not the legal entity is a VIE is based on the nature and amount of equity investment and the rights and obligations of the equity owners. Owning a variable interest in an entity does not automatically make it a VIE. For example, for a company that owns shares (equity is a variable interest) of Tesla, this is probably not a VIE. The assessment of whether or not an entity is a VIE is made when your company first invests in a legal entity or otherwise becomes involved in a legal entity. A legal entity is a VIE if you answer YES to any ONE of the following five questions:

1. Is the GAAP equity at risk (at the time of the parent company's involvement) insufficient to support the operations of the entity? Consider the following:
    - Do the equity holders have sufficient "skin in the game?"
    - Do the equity holders participate significantly in the profits and losses?
    - Can the entity obtain market rate financing without a parent company or other guarantee?
    - Does the entity have at least as much capital as similar entities?
    - Is the equity sufficient to sustain any expected losses of the entity?

2. Do the equity holders, as a group, lack the power to direct the activities of the entity through voting rights? Consider the following:
    - Do the equity holders elect a board or oversight committee that is actively involved in the affairs of the company?
    - Do the equity holders directly (or indirectly through a board or oversight committee) have the ability to make decisions affecting the company such as:
        - Setting the strategic direction of the company
        - Approving operating and capital budgets
        - Making acquisition and divestiture decisions
        - Hiring and terminating management and setting compensation

3. Do the equity owners lack the obligation to absorb the expected losses? Consider the following:
    - Are the equity owners protected in some way from losses?
    - Do the equity owners absorb the first dollar of losses of the entity, that is, the equity holders must be subject to a total loss before exposing other types of instruments to losses?
    - Do the equity holders have a guaranteed return?

4. Do the equity holders as a group lack the right to receive the expected residual returns? Consider the following:
    - Is the equity holders' return capped by agreement or other means?

5. Are the voting rights of individual investors disproportionate to profit/loss sharing ratios AND is substantially all of the entity's operations conducted on behalf of the investor that has disproportionately fewer voting rights? Consider the following:
    - Both criteria must be met.

- Any disproportionate voting rights may meet the first criteria (for example 35% voting/25% sharing).
- Substantially all criteria are subjective and includes the investor's related parties and near related parties.
- Substantially all criteria should include how important the entity's operations are to the investor.

Conclusion

In many situations, application of the VIE consolidation model can be quickly scoped out after considering the business scope exemption (and its 4 related exceptions) or determining that the legal entity is not a VIE. If, after considering these factors, the VIE consolidation model is not scoped out, there may be additional considerations to analyze in concluding that the VIE consolidation model is applicable. Once the applicability of the VIE consolidation model has been concluded, a variable interest holder must perform an analysis to determine if it is the primary beneficiary.

*****

Michael Ussery is a partner of Kral Ussery LLC, a public accounting firm delivering advisory services, litigation support and internal audits. Michael is a well-respected accounting advisor and a highly rated speaker, trainer and advisor. He has a long history of working with accounting firms, SEC registrants and privately-held companies on complex accounting and regulatory issues. Contact Michael at MUssery@KralUssery.com.

Kral Ussery LLC has assisted numerous clients on their analysis of variable interest entities and can provide expert advice on the VIE consolidation model assessment. KU serves US public and private companies to protect and grow shareholder value, as well as non-profits and governments with internal controls and in combating fraud. We assist entities with governance and in all matters relating to financial reporting, including SEC compliance, internal controls testing and remediation, IT general controls, IPO readiness, M&A transactions and US GAAP. Visit us at www.KralUssery.com.

This is an article from the Governance Issues™ Newsletter, Volume 2020, Number 3, published on September 23, 2020 by Kral Ussery LLC.

© Kral Ussery LLC. Copyright: The Governance Issues™ Newsletter is meant to be distributed freely to interested parties. However, any use of this article must credit the respective author and Kral Ussery LLC as the publisher. All rights reserved. Use of the newsletter article constitutes acceptance of our Disclaimer and Privacy Policy. To automatically receive the newsletter, go to www.KralUssery.com and register. Or, send a request to newsletter@KralUssery.com and we will register you.