

THE NEWSLETTER FROM BDO'S NATIONAL ASSURANCE PRACTICE

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FASB ISSUES ASU RE: PCC EXEMPTION FOR CERTAIN VIEs

► SUMMARY

On March 20, 2014, the FASB issued a final ASU to allow private companies to opt out of applying the variable interest entity (VIE) consolidation guidance to certain common control leasing arrangements.¹ Therefore, a private company lessee that meets the eligibility criteria and elects not to apply the VIE guidance would account for its lease under Topic 840 as either an operating or capital lease, as appropriate. Certain incremental disclosures would also be required. Early adoption is available for 2013 year-end financial statements that are not yet available for issuance. The ASU is available [here](#).

► EFFECTIVE DATE AND TRANSITION

If elected, the accounting alternative should be applied retrospectively to all periods presented. Prospective adoption is not permitted. The alternative is 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.

¹ ASU No. 2014-07, *Applying Variable Interest Entities Guidance to Common Control Leasing Arrangements, a consensus of the PCC*

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► BACKGROUND, SCOPE AND MAIN PROVISIONS

It is common for a private operating company to enter into a lease with a sister company (i.e., the lessor) for the use of the lessor's property, such as a manufacturing facility or a retail location. This situation frequently results in the operating company consolidating the lessor entity under the VIE consolidation guidance in Topic 810.

Based on its outreach and deliberations, the FASB agreed with the PCC that private companies should be permitted to elect to not apply the VIE consolidation guidance when all of the following conditions are met. Only entities that do not meet the definition of a "public business entity" under ASU No. 2013-12 are eligible (employee benefit plans and not-for-profit entities are also excluded). Private entities considering the new option are encouraged to review our recent [Financial Reporting Newsletter](#) for the formal definition of a "private company" as well as additional considerations related to adopting one or more PCC alternatives.

The eligibility criteria are as follows:

- 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.

Application of the exemption is an accounting policy election that the private company must apply to all legal entities that meet the eligibility criteria. Further, a private company must apply applicable U.S. GAAP, including the VIE consolidation guidance, to an arrangement with a lessor entity that fails one or more of the eligibility criteria.

Under criterion (a), a lease must exist between two entities that are under common control. Therefore, the exemption is not available to a private company that leases property from an entity to which it is related, but the related party is not under common control. U.S. GAAP does not formally define the term "common control." However, in practice, reporting entities commonly look to EITF Issue No. 02-5² (which was never finalized) and related guidance from the SEC. The FASB and PCC intend the notion of common control to be marginally broader under the ASU than current practice, but the ASU does not clearly articulate how much broader. Its guidance is limited to the following brief example: an entity owned by a grandparent and an entity owned by a grandchild could, on the basis of facts and circumstances, be considered entities under common control for purposes of the exemption.³ This conflicts with the SEC's current guidance and should not be extended by analogy to other areas in U.S. GAAP. Otherwise, the ASU indicates that practitioners should be able to assess common control for purposes of this exemption because it is not an entirely new concept in U.S. GAAP.

Under criterion (c), substantially all of the activities between the lessee and lessor must be limited to leasing activities, including supporting leasing activities. These activities include:

- a. A guarantee or collateral provided by the private company to the lessor's creditor for debt that is secured by the leased asset.
- b. A joint and several liability arrangement for the lessor's debt on the leased asset, in which the private company is one of the obligors.
- c. Paying property taxes, negotiating the financing, and maintaining the leased asset.
- d. Paying income taxes of the lessor when the only asset it owns is leased only by the private company or by both the private company and an unrelated party.

Additional activities between the lessee and lessor should be analyzed to determine whether they extend beyond the notion of "leasing activities," including supporting leasing activities. For example, the ASU indicates the exemption is not available if the lessee guarantees or provides collateral with respect to other lessor property that it does not lease from the lessor.

Under criterion (d), a private company may have explicitly guaranteed or provided collateral with respect to the leased asset, which the lessor may have financed with a third party such as a bank. For purposes of the exemption, the principal amount of the lessor's debt cannot exceed the value of the leased asset at the inception of the lessee's guarantee or collateral arrangement. The ASU is silent on how the private company should determine the "value" of the leased asset. Generally, this concept seems consistent with the notion of "fair value" under Topic 820, although a formal valuation may not be required to qualify for the exemption. That is, generally lenders assess the sufficiency of their collateral (i.e., the leased asset) based on appraisals or other indications of market value, rather than relying on an amortized cost "value" determined under U.S. GAAP.

Further, a private company is only required to assess the value of the leased asset at the inception of the guarantee or collateral arrangement that it provides. Reassessments based on fluctuations in the market value of the leased asset are not required. However, the private company would be

² Definition of 'Common Control' in Relation to FASB Statement No. 141

³ See BC15 of ASU No. 2014-07.

required to reassess upon a change in the contractual arrangements. For example, a reassessment would occur if the lessor refinanced its debt or the lessee modified its guarantee or collateral arrangement.

The ASU contains implementation guidance that illustrates scenarios in which the exemption is available and also when it is not.

Private companies making the election would be required to disclose i) the amount and terms of liabilities recognized by the lessor that create financial exposure for the private company, as well as ii) circumstances that are not recognized, but nonetheless expose the private company to providing financial support to the lessor. For example, the disclosures would provide the terms of the lessor's debt (principal, interest rate, maturity, etc.), as well as any economic or business incentives the private company may have to provide funds to the lessor or a history of providing such support in the past. These disclosures would replace the VIE disclosures that otherwise apply and supplement other applicable disclosures that remain in effect, such as those for leases, guarantees and related party transactions.

The ASU also deletes the example related to implicit variable interests from the Codification.⁴ This does not remove the requirement to identify implicit variable interests and analyze them under Topic 810; it simply deletes the example because it was commonly associated with the related party leasing arrangements described above.

► ON THE HORIZON

The FASB continues to deliberate its joint project with the IASB on leases. While a fully-converged standard is unlikely at this point, the basic lessee accounting model in U.S. GAAP and IFRS is still expected to require the lessee to record its leases on the balance sheet by recognizing a right of use asset and lease payment liability, similar to today's capital lease treatment. The Boards are contemplating certain limited exemptions to this requirement, but most real estate leases are expected to be capitalized. Private companies that have historically consolidated a lessor entity under the VIE guidance that elect not to continue consolidating under ASU 2014-07 should be aware that a similar "gross" balance sheet presentation will likely be required under a final leasing standard in the future. The timing of a final leasing standard is uncertain at this point.

⁴ Paragraphs 810-10-55-87 through 55-89

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