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Accounting Newsflash

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Application of AcG-15 to Private Entities

Background

It is common for an owner-managed operating company to have a variety of relationships with affiliated entities which either have common ownership or are owned by family members. In the past there was no requirement to consolidate these entities because the operating company had no equity or ownership interest in the affiliated entities.

Accounting Guideline 15 – Consolidation of Variable Interest Entities – potentially requires operating companies to consolidate these affiliated entities. AcG-15 is applicable to private entities for annual periods beginning on or after November 1, 2004 (i.e. October 2005 year ends and later). Practically speaking, this means AcG-15 is effective for all 2005 calendar-year private companies.

What is a Variable Interest Entity?

An entity is a Variable Interest Entity (VIE) when one (or more) of the following three criteria is met:

The entity has insufficient equity capital at risk to fund its operations without additional financing; or

The equity holders as a group do not possess one of the three fundamental characteristics: control, the obligation to absorb expected losses, or the right to receive expected residual returns; or

Some equity holders participate in control, losses or profits disproportionate to their equity interest, and the activities of the entity are strongly connected with an equity holder that holds disproportionately few voting rights.

VIEs might be created through the existence of any of the following:

- Equity investments / ownership interests
- Loans or notes receivable
- Guarantees
- Insurance contracts
- Derivative contracts
- Management and other service contracts
- Leases
- Project development activities

Identifying the Population of Variable Interest Entities

The greatest risk in accounting for VIEs is ensuring the population of VIEs is complete. One approach is to examine the transactions of the operating company that have the potential to create a VIE in another entity. In addition, the following procedures could be performed to identify VIEs:

- Review guarantees of the indebtedness of others
- Review investment and sales transactions, operating agreements and other contracts
- Consider whether any unwritten agreements exist with other entities
- Review minutes of meetings of board of directors and other relevant meetings

Is Consolidation Required?

Once the population of VIEs has been identified, it must be determined if the operating company is the primary beneficiary and therefore required to consolidate the VIE. The primary beneficiary, through its variable interest or combination of variable interests, will absorb the majority of the entity's losses, or receive the majority of the entity's expected residual returns, or both.

When determining if the operating company is the primary beneficiary, related parties must be considered. AcG-15 requires an enterprise with a variable interest to treat those variable interests held by related parties as its own interest. As a result, the relationship between the operating company and all other parties that hold a variable interest in the VIE must be considered.

Differential Reporting

AcG-15 provides a differential reporting option which allows qualifying entities to avoid consolidation. However, to apply the differential reporting option, all VIEs must be identified because appropriate disclosures must be included in the financial statements.

In addition, the owners must unanimously consent to the use of the differential reporting option, if they have not previously elected for non-consolidation of pre-existing subsidiaries.

Frequently Encountered Situations in Private Entities

As the following examples illustrate, some very common situations for private entities could result in the existence of VIEs that must be consolidated with the operating company.

Example 1

A manufacturing company has only one shareholder. The shareholder owns the real estate that is used by the manufacturing company through a holding company (Holdco). Holdco was initially capitalized with a 5%

equity contribution. Holdco borrowed funds from a financial institution, where the financial institution required a guarantee from the manufacturing company. The manufacturing company leases the real estate from Holdco.

Because Holdco did not have sufficient equity at risk, the lending institution required a guarantee of the loan from the manufacturing company. The manufacturing company has a variable interest in Holdco because of the guarantee it provided. In this circumstance, it should be clear that the manufacturing company is the primary beneficiary of Holdco because there is no other entity available to absorb the negative variability associated with the assets of Holdco. Essentially, the manufacturing company should consolidate Holdco.

Example 2

A manufacturing company has only one shareholder. The shareholder owns the real estate that is used by the manufacturing company through a holding company (Holdco). Holdco was initially capitalized with a 5% equity contribution. Holdco borrowed funds from a financial institution, where the financial institution required a guarantee from the sole owner of the manufacturing company. The manufacturing company leases the real estate from Holdco where the terms of the lease parallel the 15-year time period associated with the loan.

Because Holdco did not have sufficient equity at risk, the lending institution required a guarantee of the loan from the shareholder. The shareholder has a variable interest in Holdco through the guarantee of the loan. Because all related parties need to be aggregated in an effort to determine the primary beneficiary of the affiliated entity, and since the shareholder is by definition a related party to the manufacturing company, Holdco is a VIE. Because the only user of the assets owned by Holdco is the manufacturing company, the manufacturing company would be considered the primary beneficiary and should consolidate Holdco even though the guarantee was provided by the shareholder rather than the manufacturing company.

Example 3

A successful operating company (Opco), with a single shareholder, loans $100,000 without security to a corporation controlled by the shareholder's spouse (Spouseco). Spouseco was initially capitalized with $100 of share capital and a $20,000 loan, all of which has been lost through operations.

Spouseco does not have adequate equity to fund its operations; therefore it is considered a variable interest entity. Because any future losses will be absorbed by the loan from Opco, Opco would be considered the primary beneficiary and should consolidate Spouseco.

If you have any questions on Variable Interest Entities, or on anything covered in this publication, please contact your local BDO Dunwoody partner.