

Variable Interest Entities

The Financial Accounting Standards Board, in response to a trend in publicly traded companies having significant off-balance sheet activities, released FIN46(R), an interpretation of Accounting research bulletin 51, which, if consolidated and or combined with the reporting entity would potential have a significant impact on the issuing company's financial statements.. This pronouncement applies to both publicly trade and non public entities and like many well intended thoughts the practical applications are the things that horror stories are written about.

Guidelines were established that attempted to define what conditions must be met in order for a financial or non-financial interest in another enterprise to be considered an interest in a "variable interest entity" (VIE) and how it should be treated if it was so deemed such. Factors such as control, financial interdependency, the obligation to absorb losses without recourse can make an entity a VIE. Since the determination is based on facts and circumstances, each transaction must be viewed separately in the decision process. An operating lease between affiliated entities may require consolidation as a VIE into the financial statements of the owner of the VIE.

The broad definition of a VIE is any entity that meets one of the following requirements

- The reporting enterprise, its related entities, or both participate significantly in the design of the entity, and the entity is neither a joint venture or a franchisee.
- The entity is designed so that substantially all of its activities either involve or are conducted on behalf of the reporting entity or its related parties.
- The reporting enterprise and its related parties provide more than half of the total equity, subordinated debt, and other forms of subordinated financial support to the entity based upon an analysis of the fair values of the interests in the entity.
- The activities of the entity are primarily related to securitizations, other forms of asset-backed financing, or single-lessee leasing arrangements.

Its important to note that even if one of these conditions are met, the entity would not qualify as a VIE if that entity is an individual.

Confused??????? That's only the beginning. Fin 46R requires that analysis be made to determine in fact that a related entity is more like than not a VIE. This is an annual determination. The presentation of the Company's financial statements now looks significantly different because of the inclusion of such an entity. Users of the statements can't readily identify the separate assets and liabilities of the Company. Bank loan covenants based upon capital and debt ratio as determined under generally accepted accounting principle now may result in technical defaults. General creditors may either look to the assets of both the company and VIE if they rely on such statements in their credit decisions.

The most frequent VIE situation arises when a Company leases its facilities from a partnership owned by the shareholders of the Company. The building, land and improvements along with the related debt will be reflected on the balance sheet of the Company. Any negative partners capital in the VIE will effectively reduce the equity of the Company. If the owner of the same property was an individual the entity would not be combined as a VIE. Why???? Because an individual can not be a VIE!

The irony of the issue is that most bank's cross-collateralize the buildings owned by shareholders and used in the business. The bank knows about this relationship and that the VIE presentation may create covenant problems with the borrower.

Our discussion with many bankers regarding this issue has led us to the following points:

- Bank documents are being modified by many institutions to allow for a variance from GAAP as it relates to the VIE presentations
- Some institutions are accepting financial statements prepared on a tax basis in order to avoid dealing with a GAAP exception. Disclosures related to the VIE are still required
- Bankers are responsive to customer requests regarding this issue and welcome discussion over the presentation of a Company's financial statements.

The complexity of the application of this pronouncement has added significant cost for the preparation of financial statements with little benefit to the Company and the users of its statements. While practitioners, company owners and users of financial statements complain about this issue there is nothing pending to modify FIN 46(R) and so we need to both live with this issue and plan around it.

For a summary of the principle features of FIN 46 (R) just hit the hot link <http://www.fasb.org/st/summary/finsum46r.shtml> and good luck.

A better answer is getting us involved when structuring a new entity and/or entering into a business transaction with affiliated entities is one of the best ways to design a transaction to avoid the VIE abyss.