



CONSOLIDATION OF VARIABLE INTEREST ENTITIES – HOW THIS NEW RULING CAN AFFECT YOUR FINANCIAL REPORTING REQUIREMENTS



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In August of 1959 accounting standards were issued which created *Consolidated Financial Statements*. The concept of consolidating businesses where one company has controlling interest of another was born. This has generally been interpreted to mean that one entity has controlling interest (the parent) over another (the subsidiary) by exercising ownership rights. In December 2003, a new accounting standard entitled, *Consolidation of Variable Interest Entities*, changed this interpretation to include the consolidation of business enterprises which contain variable interest entities.

A variable interest entity (“VIE”) is a business which has one or more of the following characteristics:

- The total equity investment at risk is less than the expected losses (i.e., the business can not finance its own operations and relies on another for working capital);
- The equity investors do not have the ability to directly or indirectly make decisions regarding the activities of the entity (i.e., a corporation invests in a rental LLC, but the LLC is controlled by the majority shareholder of the corporation);
- The equity investors do not absorb the expected losses nor do they benefit from the right to receive the expected residual returns of the entity;
- The equity investors have voting rights that are disproportionate to their economic interests (i.e., the entity’s activities are conducted on behalf of an investor with a disproportionately small amount of voting stock).

This accounting standard can be loosely interpreted to mean that if an entity is not a self sustaining business activity in which its assets and activities are not operating for the purpose of providing a return to its investors, then the assets and operations of that entity should be consolidated with its primary beneficiary. The primary beneficiary is the business which provides the economic resources (working capital) to support the other entity.

Expected losses do not just pertain to net income but also the variability of the fair value of the assets held by the VIE (i.e. a decline in the market value of the property held by the VIE). Additionally, expected losses may include:

- Fees paid to the decision maker;
- Fees paid to the providers of guarantees of the values of all or substantially all of the entity's assets;
- Fees paid to the providers of guarantees that all or substantially all of the entity's liabilities will be paid.

An example of a variable interest would be if ABC Construction Company had one shareholder. The shareholder owns the real estate that is used by ABC Construction Company in a single member LLC. The single member of the Real Estate LLC is also the owner of ABC Construction Company. The Real Estate LLC was capitalized by a 5% equity contribution and a mortgage obtained from a bank, where the bank required a guarantee from ABC Construction Company. ABC Construction Company then leases the property back from the LLC with the lease term equal to the same 15 year term as the mortgage obtained by the Real Estate LLC.

In this example, the initial equity contribution of the LLC was not sufficient, which resulted in the bank requiring ABC Construction Company to guarantee the loan. The insufficient equity contribution and the guarantee by ABC Construction Company would constitute a VIE. ABC Construction Company is therefore the primary beneficiary and the LLC is the variable interest entity. This business formation meets two of the four VIE characteristics.

The effective date for this accounting standard varies upon the type of reporting entity. For public entities that are small business issuers, the effective date is no later than the end of the first reporting period that ends after December 15, 2004. For non-public entities, the effective date is the first annual period beginning after December 15, 2004. However, for non-public entities with an interest in an entity that is subject to this accounting standard and that was created *after* December 31, 2003, the interpretation shall apply to that entity immediately.

The *Consolidation of Variable Interest Entities* is going to greatly impact the manner in which companies report their activities for years to come. Additionally, given the complexity of applying this interpretation and the reluctance of reporting entities to consolidate their VIE's there will undoubtedly be a significant amount of misapplications and misstated financial statements in the near future. This standard applies to a number of different situations which should be evaluated on an individual case-by-case basis. Contact Bill McNamara, CPA - Director of the Construction Services Group at Cowan, Guteski & Co, P.A., at 732-349-6880 extension 116 or bmcnamara@cowanguteski.com for more information on how this new accounting standard could impact you.



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