

Consolidation Relief for Related Parties

The Financial Accounting Standards Board recently completed a 16-month project to further simplify variable interest entity¹ (VIE) consolidation guidance for related parties under common control. Accounting Standards Update (ASU) 2018-17, *Consolidation (Topic 810), Targeted Improvements to Related Party Guidance for Variable Interest Entities*, affords private companies an accounting policy election to not apply VIE guidance to commonly controlled separate legal entities, in certain situations. The ASU also updates the guidance for determining whether a decision-making fee is a variable interest, which likely will result in more decision makers not consolidating VIEs.



Private Company Accounting Alternative

These amendments supersede and expand the private company alternative for common control leasing arrangements from ASU 2014-07, *Applying Variable Interest Entities Guidance to Common Control Leasing Arrangements*. The amendments apply to reporting entities that are required to determine whether they should consolidate a legal entity under the VIE guidance in Subtopic 810-10, *Consolidation—Overall*, including private companies that have elected the accounting alternative for leasing arrangements under common control pursuant to ASU 2014-07. If elected, a private company should:

- Apply the accounting alternative to **all** current and future legal entities under common control that meet the criteria for applying this alternative. The alternative cannot be applied to select common control arrangements
- Continue to apply other consolidation guidance—particularly the voting interest entity guidance—unless another scope exception applies

Scope

This alternative does not apply to public business entities (PBE), not-for-profit entities and employee benefit plans within the scope of Topics 960, 962 and 965 on plan accounting. The ASU allows a private company (reporting entity) to elect an accounting policy to not apply VIE guidance to legal entities under common control (including common control leasing arrangements) if the following conditions are met:

- The reporting entity and the legal entity are under common control
- The reporting entity and the legal entity are not under common control of a PBE
- The legal entity under common control is not a PBE

¹ A VIE is a legal entity in which consolidation is not based on a majority of voting rights. A controlling financial interest in the VIE model requires both of the following:

- a. The power to direct the activities that most significantly affect the VIE's economic performance
- b. The obligation to absorb losses of the VIE that could potentially be significant to the VIE or the right to receive benefits from the VIE that could potentially be significant to the VIE

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- The reporting entity does not directly or indirectly have a controlling financial interest in the legal entity when considering the general subsections of this topic. The VIE subsections shall not be applied when making this determination

See an example in [Appendix A](#).

Disclosure

Disclosure about an entity's involvement with and exposure to the legal entity under common control is required. These disclosures only apply if the legal entity under common control is not consolidated by the private company reporting entity. The below disclosures are in addition to the disclosures required by other guidance, *i.e.*, Accounting Standards Codification (ASC) 460, *Guarantees*; ASC 850, *Related-Party Disclosures*; and ASC 842, *Leases*. Disclosures can be combined in a single note or by including cross-references within the notes to the financial statements. New disclosures include all of the following:

- (1) The nature and risks associated with a reporting entity's involvement with the legal entity under common control
- (2) How a reporting entity's involvement with the legal entity under common control affects the reporting entity's financial position, financial performance and cash flows
- (3) The carrying amounts and classification of the assets and liabilities in the reporting entity's statement of financial position resulting from its involvement with the legal entity under common control
- (4) The reporting entity's maximum exposure to loss resulting from its involvement with the legal entity under common control. If the reporting entity's maximum exposure to loss resulting from its involvement with the legal entity under common control cannot be quantified, that fact shall be disclosed
- (5) If the reporting entity's maximum exposure to loss exceeds the carrying amount of the assets and liabilities as defined in (3) above, qualitative and quantitative information to allow users of financial statements to understand the excess exposure. That information shall include, but is not limited to:
 - The arrangements' terms, considering both explicit and implicit arrangements that could require the reporting entity to provide financial support to the legal entity under common control, *i.e.*, implicit guarantee to fund losses
 - Events or circumstances that could expose the reporting entity to a loss

Determining whether an implicit guarantee exists is based on facts and circumstances. Those facts and circumstances include, but are not limited to, whether:

- The reporting entity has an economic incentive to act as a guarantor or make funds available
- The reporting entity has acted as a guarantor for or made funds available to the legal entity in the past

Decision-Making Fees

ASU 2018-17 also amends the guidance for determining whether a decision-making fee is a variable interest. This amendment is applicable to all entities, not only private companies. This is the first step in determining whether a decision maker applies the rest of the consolidation guidance. The amendments require organizations to consider indirect interests held through related parties under common control on a **proportional** basis rather than as the equivalent of a direct interest in its entirety (as currently required in generally accepted accounting principles). This is consistent with how indirect interests held through related parties under common control are considered for determining whether a reporting entity must consolidate a VIE pursuant to ASU 2016-17. For example, if a decision maker or service provider owns a 20 percent interest in a related party and that related party owns a 40 percent interest in the legal entity being evaluated, the decision maker or service provider's indirect interest in the VIE held

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through the related party under common control would be considered the equivalent of an 8 percent direct interest for determining whether its fees are variable interests.

These amendments likely will result in more decision makers not consolidating VIEs.

Effective Date & Transition

For entities other than private companies, the ASU is effective for fiscal years beginning after December 15, 2019, including interim periods. The ASU is effective for a private company for fiscal years beginning after December 15, 2020, and interim periods beginning after December 15, 2021. The amendments should be applied retrospectively with a cumulative-effect adjustment to retained earnings at the beginning of the earliest period presented. Early adoption is permitted.

Consolidation

If a legal entity is required to be consolidated as a result of this ASU's adoption, the initial measurement of the legal entity's assets, liabilities and noncontrolling interests will depend on whether determining their carrying amounts is practicable.

- If practicable, the carrying amounts would be the balances the assets, liabilities and noncontrolling interests would have been carried at in the consolidated financial statements if this ASU had been effective when the reporting entity first met the consolidation criteria
- If determining the carrying amounts is not practicable, the legal entity's assets, liabilities and noncontrolling interests would be measured at fair value at the ASU's adoption date. Any difference between the net amount added to the statement of financial position of the reporting entity and the amount of any previously recognized interest in the newly consolidated legal entity shall be recognized as a cumulative-effect adjustment to retained earnings at the beginning of the earliest period presented.

An entity that is required to consolidate may elect the fair value option (FVO) provided in Subtopic 825-10, but only if the reporting entity elects the option for all financial assets and financial liabilities of that legal entity that are eligible for the FVO. This election shall be made on a legal-entity-by-legal-entity basis. If elected, additional disclosure is required in the period of adoption.

Deconsolidation

If deconsolidation of a legal entity is required as a result of adoption, the initial measurement of any retained interest in the deconsolidated former subsidiary depends on whether the determination of its carrying amount is practicable. The carrying amount refers to the amount at which any retained interest would have been carried if this ASU had been effective when the reporting entity became involved with the legal entity or no longer met the consolidation criteria. If determining the carrying amount is practicable, the reporting entity would initially measure any retained interest in the deconsolidated former subsidiary at its carrying amount at the date these amendments first apply.

If determining the carrying amount is not practicable, any retained interest in the deconsolidated former subsidiary shall be measured at fair value at the date this ASU first applies.

VIE Analysis

The determinations of whether a legal entity is a VIE and which reporting entity, if any, should consolidate the legal entity are made as of the date the reporting entity became involved with the legal entity or the date of a qualifying reconsideration event. An entity would use the most recent of these dates to apply the amendments within this ASU for purposes of retrospective application. If, at transition, it is not practicable for a reporting entity to obtain the information necessary to make the VIE determinations, the reporting entity shall make the determinations as of the date this ASU is first applied. The consolidating entity would measure the assets, liabilities and

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noncontrolling interests of the legal entity at fair value as of the ASU's adoption date. For securitizations or other forms of asset-backed financings, whereby the VIE's assets can be used only to settle the VIE's obligations, the VIE's assets and liabilities may be measured at their unpaid principal balances (as an alternative to a fair value measurement) at the ASU's adoption date. This measurement alternative does not preclude the need for the primary beneficiary to recognize any accrued interest, an allowance for credit losses or other-than-temporary impairment, as appropriate. Other assets, liabilities or noncontrolling interests, if any, that do not have an unpaid principal balance, and any items that are required to be carried at fair value under other accounting guidance, would be measured at fair value.

Transition Disclosures

An entity also must include the following accounting principle change disclosures in the interim and annual period of adoption:

- The nature of and reason for the change in accounting principle, including an explanation of why the newly adopted accounting principle is preferable
- The method of applying the change, including all of the following:
 - A description of the prior-period information that has been retrospectively adjusted, if any
 - The cumulative effect of the change on retained earnings or other components of equity or net assets in the statement of financial position as of the beginning of the earliest period presented
 - If retrospective application to all prior periods is impracticable, disclosure of the reasons and a description of the alternative method used to report the change

For additional guidance, contact your BKD advisor.

Contributor

Anne Coughlan
Director
317.383.4000
acoughlan@bkd.com

Appendix A – Accounting Alternative—Common Control Exists

Assume the following:

- Entities A (Parent), B (the reporting entity), C (a legal entity) and E (a legal entity) are all private companies
- Entity A holds a majority of the voting shares of Entities B and C
- Entity C holds a majority of the voting shares of Entity E

Based on the guidance, Entity A has a controlling financial interest in Entities B and C because it directly holds a majority of the voting shares in those entities, and no circumstances indicate control does not rest with the majority owner. Entity C also has a controlling financial interest in Entity E because it directly holds a majority of the voting shares in this entity. Therefore, Entity A controls Entity E through Entity C's controlling financial interest in Entity E. For the purposes of analyzing scope, Entities B, C and E are under common control of Entity A.

Assuming the other scope criteria are met, Entity B (the reporting entity) is eligible to apply the accounting alternative to Entity C and Entity E.

If Entity B directly holds a majority of the voting shares of Entity E, and no circumstances indicate control does not rest with the majority owner, **Entity B would not be able to apply the accounting alternative to Entity E** because the scope criteria would not be met. In other words, Entity B would conclude it holds a controlling financial interest in Entity E when considering only the general subsections of ASC 810 and not the VIE subsections.