

Variable Interest Entity (VIE)

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Introduction

A variable interest entity is defined as a legal entity whereby an investor has a controlling interest even without having a major share of its ownership. It is, however, reported by the Financial Accounting Standards Board (FASB) in the U.S. to be an entity in which the investor has some controlling interest, although the controlling interest is not based on the majority's rights of voting. Therefore, for this reason, variable interest entities (VIE) become subject to consolidations under various conditions. Also, variable interest entities have primary beneficiaries and the party that holds major variable interests only if the primary beneficiary stands to be a company; thus, all the holdings should be listed within the balance sheets of the company. (Board of Governors of the Federal Reserve System, 2021)

Variable interest entities are one of the most common accounting functions within financial institutions to be used together with their subprime mortgage-backed securities (MBS). This means that they can be developed to be a special-purpose vehicle (SPV) in order to let the firms avoid always listing their assets on their balance sheets. VIE remarks that how different financial firms get exposed to special-purpose vehicles can change them, as it is pivotal in deciding whether it can be banished from the balance sheets or not. However, corporations make utilization of any vehicle in an entity such as VIE so as to provide or come up with investments that have financial success without even putting the entire firm in jeopardy. Moreover, the main issues in a VIEs are similar to the issues of SPVs in past years and therefore, they are frequently termed as a go-to method of hiding various factors, such as subprime exposures.

FASB Interpretation Number 46R

This is an accounting research bulletin and interpretation that deals with consolidations of different variable interest entities. This means that federal securities and laws require a publicly traded company to submit financial reports and its operations information. Therefore, their relationships with VIEs should be revealed on the 10-K forms that these companies file. This enables the FIN 46 to outline the accounting rules that apply to such businesses. In this case, companies generally establish variable interest entities in order to sustain financial assets, which include those that are actively involved. This includes products such as those involved in conducting research as well as the development of operations (R&D) and entities that fill roles that are more passive.

An example of variable interest in today's world requires off-balance sheets in their financing schemes. A common arrangement is the establishment of special purpose entities that have sole

purposes, which are limited losses and liabilities on financial statements which are due to technicalities in the rules of consolidations. However, under old rules, companies were only required to get consolidated with partially-owned subsidiaries if they owned some controlling interests, which are generally received to mean 50% or as higher ownership or even voting rights. In other words, some organizational structures, including LLCs and other assets, are seen to be flexible in terms of voting and ownership. This means that they can be previously used in cases of hiding liabilities. One of the variable interest entities is as follows. (Investor.gov, 2021)

VIE Ownership and Consolidation Example

A Friends Company initiates a Little Company as a third party, thus taking small ownership of 5% interest, “even though it provided 90% of Little’s Company capital.” This means that this new company gets a loan in which it is supposed to construct and build a manufacturing facility. This is because it is quite small, young and new; however, Friends Company is supposed to guarantee the loan given to it. For instance, the facilities produce some small parts that are utilized by Friends Company in their manufacturing processes. Thus, this means that Friends Company purchases everything that is manufactured or produced by Little Company. In a situation where Little Company incurs losses money, then Friends Company will provide it with more capital in order to keep the Little Company flowing. Out of this example, it is clear that Friends Company benefits most from the operations of Little Company, therefore, covering and financing their losses with capital is a clear responsibility. In cases of normal consolidation rules, Friends Company is not supposed to go ahead and report the Little Company’s assets as well as the loan related to its consolidated statements.

In VIEs, an establishment of FIN 46R becomes a two-step test process in determining “whether organization subsidiary needs to have being consolidated in bases of the alternative variable interest rules.” This means that for a variable interest to exist, there should be first, in a situation where cash flows to and from the entities, which could change the basis on which the makeup of the liabilities and assets is done. However, from the above-given example, Friends Company might lose more money in the process of investing in Little Company if the company does not control its costs in production or even defaults on its loan. For a case where it is determined that the existence of variable interests, the primary beneficiaries of the entity should consolidate the entity’s liabilities as well as assets as if the company has an ownership interest of 50%. VIEs, in other words, can be complex organizations that have deeper discussions on their progression in accounting and financial recording. Furthermore, specifics about company consolidations and processes might not be that relevant to the understanding of variable interest entities as well as how much they should be accounted for.

The consolidation of variable interest entities had to be separated from in today’s world of accounting due to some of the following reasons. There were several accounting scandals whereby some types of variable interest entities became used in the structuring of transactions, which excluded liabilities and assets in times of auditing consolidated financial statements. This meant that some types of VIEs, as well as for purposes of such vehicles, vary considerably (Lange). However, in the real sense, the

owner of the private companies recurrently establishes the lesser entities as a VIE for taxes, liability reasons, and estate planning rather than be utilized for the purpose of developing structures relevant to off-balance-sheet arrangements. Through Accounting Standards Codification (ASC) VIEs are consolidated generally with other related entities such as lessee of the operating company issued under common controls. Therefore, in private companies, financial statement auditors and prepares have concluded suggestions that to avoid scandals, they can, however, implement strategies such that the third parties do not realize any financial information that might be of common control in leasing arrangements for decisions to be useful.

The various variable interest entities have created new rules for reporting financial statements due to some of the following reasons. Due to recent updates of Accounting Standards Update (ASU) in 2009-17, Consolidation (Peterson), the FASB codified the variable interest entities with significant changes so as to analyze the required financial statements when determining if a company should consolidate variable interest entities or not. This includes special purpose entities in the financial statement. These new rules were amended to incorporate the Financial Accounting Standards Board into consolidation analysis. This meant that the rules required would enhance the disclosures of any company's involvement in VIEs as well as related financial recording risks. These rules are created to focus on the qualitative assessments of power as they are intended to be more effective in identifying the company that holds some of the control measures of financial interests within VIE. They were also created to enhance the sharing of power among multiple unrelated parties held together in order to direct the organization's activities or decisions, which could be put across about those activities requiring much consent of each other party. (U.S. Securities and Exchange Commission, 2021)

Auditing and Reporting Problems

Some of the problems that were incurred in its recent history include poor auditing of the liabilities and assets. This led to poor reporting of the Balance sheets due to general losses. In other cases, the consolidations become irrelevant to the auditor, probably in private companies. This is because most of them set their focus on tangible net worth and cash flows of those companies that stand alone as private and lessee instead of the consolidated assets and cash flows. They also under problems such as encountering distorting of the consolidated financial statements positions of both the lessee entity and lessor entity due to assets being held by the lessee and lessor entity, which would be beyond creditors' reach.

Accounting standards hurt the investors in ways that their assets, incomes, or gains from different liabilities are not recorded in the balance sheets and other financial statements. However, the standard accounting auditors came up with various solutions solving financial reporting to help solve the situations. Such challenges to investors can be solved and through the utilization of the financial standards, the investor can benefit. However, for companies that are mid-sized and with two or three entities, their most common approach is done through let the outside accounts or investors deal with the incident. This means that in case a company is supposed to answer its bank or even the few

owners, therefore, the consolidated statements seem generally not important. And for its accounting, it should be done once a year or less. Furthermore, if those auditors follow strict rules in an independent manner, they should not be allowed to perform the consolidations for your company. This is because some of the small accounting firms can generally handle them in a very normal way, thus avoiding losses.

In conclusion, from the discussed points, the guidance interpreted by no. 46R seems to be causing reporting entities to account for financial statements in a form that determines whether the affiliated entities require consolidations of primary reporting entities or not. However, historically, the decision has been based almost exclusively on the analysis of the voting interests. Moreover, today, the primary beneficiaries will be required to base their consolidation on the new criterion. Therefore, the practical results will be that most of the reporting entities will be utilized to add significant liabilities and assets onto their balance sheets. (Chen, 2021)

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