SHARTSIS FRIESE LLP

One Maritime Plaza ♦ Eighteenth Floor
San Francisco, California 94111-3598

Public Company Reporting Obligations in Connection with Variable Interest Entities[1]

To navigate through regulatory restrictions or for strategic reasons, public companies may need to rely on entities in which they do not necessarily have an ownership interest or the majority of voting rights. For accounting purposes, a public company may need to treat such entities as variable interest entities ("VIEs") and consolidate their results into its financial statements as appropriate. If a public company's business involve VIEs, this can present challenges in meeting reporting obligations under the requirements of the United States Securities and Exchange Commission (the "SEC"). This article seeks to outline considerations that a public company should take into account in determining whether and how to disclose transactions, relationships and arrangements involving VIEs.

I. Variable Interest Entities and Requirement for Consolidation

The term "variable interest entity" as used by the United States Financial Accounting Standards Board (the "FASB") in its Accounting Standards Codification ("ASC") 810-10 generally refers to an entity in which a public company[2] has a variable interest that is not based on having the majority of voting rights. VIEs are primarily entities that lack sufficient equity to finance their activities without financial support from others and/or whose equity holders, as a group, lack one or more of the following characteristics: ability to make decisions, obligation to absorb expected losses and right to receive expected residual returns.[3]

A public company is generally deemed to have a controlling financial interest in a VIE when it (i) has the power to direct the VIE's activities that most significantly impact the VIE's economic performance, and (ii) has the obligation to absorb losses of the VIE or the right to receive benefits from the VIE that could potentially be significant to the VIE.[4] As the VIE's primary beneficiary,[5] the public

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[1] This article focuses on a U.S. public company's reporting obligations in connection with VIEs formed domestically and does not attempt to address reporting obligations with respect to VIEs overseas.
[2] Generally including any majority-owned subsidiary of the public company.
[3] *See* FASB ASC 810-10.
[4] *Id.*
[5] Only one company is expected to have the power to direct the activities of a VIE that most significantly impact its economic performance and be identified as its primary beneficiary. *See* FASB ASC 810-10.

company is required to consolidate the VIE and include the VIE's assets, liabilities and results of operations in its consolidated financial statements.[6]

II. Recognition of Variable Interests

A variable interest that a public company has in another entity may manifest itself outside of ownership or equity investment and could be a contractual or other monetary interest that changes with such entity's fair value.[7] A variable interest may result explicitly from an agreement or instrument or implicitly from a relationship or arrangement. Examples of variable interests include operating leases, service contracts, debt instruments and guarantees.[8] For example, a public company may provide decision-making services to another entity.[9] Some states laws prohibit business entities with non-physician owners from practicing medicine, which are generally referred to as the corporate practice of medicine.[10] States that have corporate practice of medicine laws require only physicians to exercise control over medical decisions. A healthcare management company with public stockholders, however, may enter into long-term services agreements with professional medical corporations to provide non-medical management and administrative services to them. If that is the case, the public company could be the primary beneficiary of such professional corporations and have the exclusive authority (such as through contractual arrangements or majority representation on their decision-making bodies) over the professional medical corporations' non-medical decisions that most significantly affect their economic performance.

Variable interests in a VIE held by a public company and its related parties and de facto agents should generally be treated as one interest for purposes of determining who is the primary beneficiary.[11] Since a public company could have key management personnel serving as nominee equity holders of other entities, especially where corporate practice of medicine laws prohibit it from owning medical entities, those entities could be deemed as its VIEs.

Further, variable interests could be established through liens and security interests granted to a public company in VIEs' assets and/or ownership interests,

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[6] *See* FASB ASC 810-10.
[7] *Id*.
[8] *Id*.
[9] *See* FASB ASC 810-10.
[10] For example, see Section 2400 of the California Business and Professions Code.
[11] *See* FASB ASC 810-10.

including the right to convert all or a portion of its loans to the VIEs' equity, where the VIEs do not have sufficient financial resources to carry out purported activities.

Note that VIEs could in turn have variable interests in and be considered as the primary beneficiaries of other entities, which should also be consolidated.

III. The Current Reporting Landscape

In connection with the notes to financial statements filed with their annual and quarterly reports, the SEC staff has asked public companies to explain their involvement with VIEs,[12] including how such involvement affects their financial position, financial performance and cash flows, and to support how they determined whether they were or were not the primary beneficiary of a VIE.[13]

The SEC staff appears to be interested in examining whether an entity should be consolidated or not. The SEC has questioned both consolidated VIEs that a public company believes it is their primary beneficiary and entities that a public company holds a significant variable interest in but does not consider itself to be their primary beneficiary and thus are not consolidated.[14] For a consolidated VIE, the SEC staff focused on a public company's qualitative assessment of its power to direct the activities of the VIE that are economically significant and its rights to economic benefits or obligations to absorb losses, including significant factors considered and judgments made by the company.[15] The SEC staff seemed to require public companies to base their determinations on the particular VIE's structure, purpose, and design.[16] The SEC staff generally expects public companies to avoid making boilerplate disclosures of the facts and circumstances they evaluated to determine the primary beneficiary and reach their consolidation conclusions. In this regard, the SEC staff has cautioned that merely listing the contractual arrangements between a public company and a VIE does not provide

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[12] For example, see SEC's comment letter dated March 31, 2016 to Target Corporation in connection with its annual report on Form 10-K for the fiscal year ended January 30, 2016.

[13] For example, see SEC's comment letter dated July 22, 2010 to Affinia Group Intermediate Holdings Inc. in connection with its annual report on Form 10-K filed on March 17, 2010.

[14] For example, see SEC's comment letter dated May 30, 2012 to Granite Construction Incorporated in connection with its annual report on Form 10-K for the fiscal year ended December 31, 2011.

[15] For example, see SEC's comment letter dated December 12, 2012 to Fortress Investment Group LLC in connection with its annual report on Form 10-K for the fiscal year ended December 31, 2011. See also, SEC comment letter dated August 10, 2011 to Discovery Communications, Inc. in connection with its annual report on Form 10-K for the fiscal year ended December 31, 2010.

[16] For example, see SEC's comment letter dated January 13, 2017 to Argan, Inc. in connection with its annual report on Form 10-K for the fiscal year ended January 31, 2016.

sufficient insight into the judgments that the company made in evaluating whether to consolidate the VIE.[17] In addition, the SEC staff required public companies to separately present, on the face of their balance sheets, assets of consolidated VIEs that can be used only to settle obligations of the consolidated VIEs and liabilities of consolidated VIEs for which creditors (or beneficial interest holders) of the VIEs do not have recourse to the general credit of the primary beneficiary.[18]

Also, in its annual and quarterly reports, a public company is required to discuss its off-balance-sheet transactions, agreements or other contractual arrangements to which an entity not consolidated with the public company is a party.[19] While arrangements between a public company and a consolidated VIE are not deemed off-balance sheet, this reporting obligation does include arrangements with a VIE where the company is not the primary beneficiary of the VIE. [20] The SEC Division of Corporation Finance specified a list of obligations (including contingent obligations) of a public company that could arise out of arrangements with such a VIE, including where the VIE provides financing, liquidity, market risk or credit risk support to, or engages in leasing, hedging or research and development services with the company, which should be disclosed if material.[21]

Outside the notes to financial statements, however, there is only limited SEC guidance as to whether a public company's other reporting obligations under its periodic reports or proxy statements should encompass its VIEs.

A significant acquisition or disposition (for example, if the assets in question exceeded 10% of the total assets of the public company and its consolidated entities) otherwise than in the ordinary course of business by a VIE that is consolidated in the public company's financial statements is required to be reported on the company's current report on Form 8-K under Item 2.01 thereof.[22]

In its annual reports or proxy statements, a public company is generally required to disclose transactions with related persons (above certain thresholds and

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[17] For example, see SEC's comment letter dated April 21, 2015 to Celanese Corporation in connection with its annual report on Form 10-K for the fiscal year ended December 31, 2014.
[18] For example, see SEC's comment letter dated May 30, 2012 to Granite Construction Incorporated in connection with its annual report on Form 10-K for the fiscal year ended December 31, 2011.
[19] See 17 CFR 229.303(a)(4).
[20] See Section 9230 of the SEC Division of Corporation Finance's Financial Reporting Manual.
[21] *Id.*
[22] See Section 2005.8 of the SEC Division of Corporation Finance's Financial Reporting Manual and the related note thereto and the SEC's Form 8-K, Item 2.01.

subject to exceptions), in which such persons had or will have a material interest.[23] Such related persons include directors, executive officers and more than 5% stockholders of the company. It is unclear as to whether the company needs to disclose transactions between a consolidated VIE and the company or any of its subsidiaries where an executive officer of the company serves as a nominee equity holder of the VIE for the benefit of the company or where a consolidated VIE holds a more than 5% ownership interest in the company. While it does not seem unreasonable to take the position that this reporting obligation does not intend to capture transactions between the company and its consolidated entities, on the face of the requirement, including its related instructions, such transactions are not explicitly excluded. On the other hand, a public company should consider whether disclosing related person transactions between it or any of its subsidiaries and a VIE that is not consolidated with the company is required or at least appropriate.

Similarly, in its annual reports or proxy statements, a public company is generally required to disclose all compensation awarded to, earned by, or paid to its named executive officers and directors for their services rendered in all capacities to the company and its subsidiaries.[24] This requirement, including its related instructions, does not specifically include compensation received from the public company's consolidated VIEs. On the one hand, one could argue that the intent of this reporting obligation should extend to compensation for services rendered to a consolidated VIE; on the other hand, the requirement, including its related instructions, does not explicitly provide that on its face, and one could also argue that a VIE, which usually is a private company, has a different set of stockholders than the public company and operates under a different corporate governance regime, and therefore, should not be subject to the heightened public company standards that often involve stockholder vote and extensive disclosure.

IV. Conclusion

For a public company that uses the VIE structure, to provide adequate information to investors and avoid comment letters from the SEC staff, we suggest that a public company proactively consider, in its SEC filings (including its annual and quarterly reports), enhancing disclosures of its consolidation accounting policies and conclusions, including providing a robust analysis as to why it believes itself to be or not to be the primary beneficiary of a VIE. Similarly, it should vigilantly monitor acquisitions and dispositions by its consolidated VIEs so

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[23] See 17 CFR 229.404.
[24] See 17 CFR 229.402.

that it can timely meet reporting obligations that could be triggered by such transactions. With respect to the reporting requirements that could involve but do not explicitly refer to VIEs, we suggest that a public company indicate whether its relevant disclosures encompass transactions, relationships and arrangements with VIEs, and if not, indicate that VIEs have been disregarded for certain disclosures, demonstrating that there may be limitations to the information provided by it.

P. Rupert Russell, Partner
SHARTSIS FRIESE LLP
RRussell@sflaw.com
(415) 773-7243

Jiang Bian, Associate
SHARTSIS FRIESE LLP
JBian@sflaw.com
(415) 773-7377