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VIE-ing with SOX

New Requirements for the Consolidation of Variable Interest Entities

The Financial Accounting Standards Board issued guidance in June 2009 for the consolidation of a variable interest entity (VIE), which may have significant implications to a reporting enterprise's internal control over financial reporting and its compliance with SOX Section 404(a).

Management must reassess its internal control procedures for identifying VIEs and determine whether they should be consolidated, as well as extend its ongoing evaluation of internal controls to include newly consolidated entities.

Furthermore, other than for a few exceptions, the SEC generally does not allow for the exclusion of the assessment of internal controls over financial reporting in the consolidation of VIEs. The staff believes that the registrant generally has the right or authority to assess internal controls of a newly acquired business. Also, the registrant has a period of more than a year to complete such an assessment.

Organizations have **traditionally approached risk oversight** by managing the individual risk buckets or silos.

Internal Control Considerations for the Consolidation of VIEs

There are significant implications under FASB's new guidance regarding an entity's internal control over financial reporting and its compliance with SOX Sec. 404(a). Management needs to assess any material weakness in consolidation of a VIE, as defined by the Public Company Accounting Oversight Board in Appendix A of Auditing Standards No. 5 (AS 5), *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements* and Statement on Auditing Standards No. 115 (SAS 115), *Communicating Internal Control Related Matters Identified in an Audit*.

Furthermore, a system of internal control should properly identify a VIE for consolidation purposes at the outset or on an ongoing basis. If a VIE's consolidation significantly impacts the consolidated financial statements of a registrant and the VIE is not properly identified for consolidation purposes at the outset, the subsequent determination that the entity is a VIE could result in a material weakness and possibly restatement of the financial statements.

Moreover, the system of internal controls should address the valuation of assets of the VIE that is now reflected on the consolidated financial statements of the registrant. Management should obtain an understanding of the assets held by the VIE and different valuation techniques used to determine the value of such assets.

SEC Interpretive Guidance

In 2007, the SEC issued an interpretive guidance regarding evaluation and assessment of internal controls over financial reporting. The guidance describes a top-down and risk-based approach that enables management to focus on those controls that deal with the risk of a material misstatement on its financial statements.

In April 2010, the Center of Audit Quality issued an alert summarizing the SEC's views related to the adoption of ASU 2009-17 and its impact on the effectiveness of registration statements that a registrant has filed.

The SEC staff's FAQ nos. 1 and 3 deal with instances where a registrant lacks the ability to dictate or modify the internal controls of a VIE. For example, even though the registrant has to include the financial results of a VIE on its consolidated financial statements, it may not have the legal or contractual rights or authority to make an assessment of internal controls over financial reporting of the newly consolidated entity.

The SEC staff concluded that a registrant may scope out a VIE in existence prior to Dec. 15, 2003, from the assessment of internal controls over financial reporting even though it continues to consolidate that VIE. The exclusion is due to registrant's lack of right or authority or lack of practical ability to make an assessment of the VIE's internal controls over financial reporting.

A similar exception is available for an entity accounted for via proportionate consolidation in accordance with ASC 810-10-45-14 if the registrant lacks the ability to assess its internal controls over financial reporting. In certain industries the investor-venturer may account for its pro rata share of the assets, liabilities, revenues and expenses of the venture in its financial statements.

The SEC also provided for a short deferral of assessment of internal controls over financial reporting of the newly acquired businesses. In this situation, a registrant acquires a business during the year, but finds

> Under the **new VIE guidance**, there are significant implications regarding an entity's internal control over financial reporting and its compliance with SOX Sec. 404(a).

it not feasible to complete its assessment of internal controls over financial reporting by the end of the year. The SEC permits exclusion of this assessment for newly acquired businesses under such circumstances for the first year of acquisition. Nevertheless, this exclusion is only available in the first year that consolidation occurs, and the registrant should make the internal controls assessment for the VIE in the second year and the following years.

The SEC generally does not allow exclusion of an internal controls assessment in consolidation of VIEs other than the few exceptions noted above. This position is aligned with FASB's views regarding consolidation of VIEs. ASC 805, *Business Combinations*, calls for consolidation of parent and subsidiary as an economic unit. The essence of this guidance is that the accounting results of a VIE, as a whole, should be merged with the operation results of the primary beneficiary—proportionate to its percentage of interest. Since the guidance views the primary beneficiary and VIE together as an economic unit, it has some merit that VIE be the subject of the same SOX rules as the primary beneficiary.

Planning for Assessment of Internal Controls

Management and the registered public accountant have at least until the end of the fiscal year to report on the effectiveness of a consolidated VIE's internal controls over financial reporting. However, the controls of the VIE must be in place and operating effectively before the end of the fiscal year to give management and the registered public accountant ample time to assess their adequacy. Therefore, it is important for the registrant to plan for the assessment of the internal controls of a VIE as early as possible.

Assessment of Internal Controls

Organizations have traditionally approached risk oversight by managing the individual risk buckets or silos. However, they have an opportunity to embrace a top-down, whole-enterprise perspective of risk oversight recommended by the Committee of Sponsoring Organizations of the Treadway Commission.

This implies that management should start asking, "What can go wrong?" at the consolidated financial statement level. This should also work its way down to the individual controls. The next step is to focus on entity level controls: What has changed at this level and in the operating environment as a result of the consolidation of the VIE, and do these changes pose new risks in the consolidated financial statements?

Then, based on the entity level evaluation, it needs to identify any material accounts and significant classes of transactions and relevant assertions related to those accounts.

Assessment methodologies built around the top-down approach are effective and allow management to progressively eliminate control

wantmore?

Variable Interest Entities

In June 2009, FASB issued Statement of Financial Accounting Standards No. 167 (SFAS 167), Amendments to FASB Interpretation No. 46(R), codified under Accounting Standards Codification Topic No. 810 (ASC 810), Consolidation. Accounting Standard Update 2009-17 (ASU 2009-17), *Improvements to Financial Reporting by Enterprises Involved with Variable Interest Entities* codified SFAS 167 under Topic 810. This guidance is effective as of the beginning of a reporting enterprise's first annual reporting period that begins after Nov. 15, 2009, and for interim periods with the first annual reporting period.

ASC 810 and ASU 2009-17 define a VIE as an entity subject to consolidation by a primary beneficiary, which is a variable interest entity holder deemed to have the controlling financial interest(s) in the VIE.

A VIE possesses one of the following characteristics:

- It cannot finance its own activities without any subordinated financial support.
- The holders of equity interest, as a group, do not possess the power to direct the activities of the company through voting rights; the obligation to absorb expected losses or the right to receive expected residual returns (management derives the expected losses and expected residual returns based on the estimated cash flows); and disproportionate voting rights in comparison to economic interest.

A VIE is generally subject to a risk and reward model rather than voting interest. Under the voting interest model, the entity that has more than 50 percent of voting rights usually consolidates the entity, but a primary beneficiary under the risk and reward model consolidates a VIE regardless of its percentage of interest in the entity.

The amended guidance requires that a primary beneficiary ("a consolidator") assesses qualitatively whether it has the power to direct matters that impact the activities of a VIE or has the obligation to absorb losses or receive benefits from the VIE that are deemed to be significant.

ASU 2009-17, in contrast with the previous guidance, requires an ongoing assessment of a VIE for consolidation purposes. This implies that characterization of an entity from a VIE to a voting interest model and vice versa might change throughout the life of an entity.

considerations related to immaterial accounts and transactions, and non-relevant assertions.

President Obama signed into law the Dodd-Frank Wall Street Reform and Consumer Protection Act July 21, 2010, which exempts non-accelerated filers (registrants with less than $75 million in public float as of the end of the second quarter of their fiscal years) from the internal control audit requirements of SOX Sec. 404(b). Nevertheless these companies must comply with Sec. 404(a), which requires the management to perform and disclose its own assessment of internal controls over financial reporting.

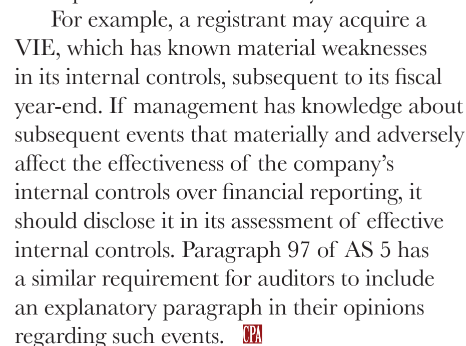
SOX 404 Disclosure Requirements for Consolidation of VIEs

Item 4 of Form 10-Q requires that the registrant disclose in its interim periods whether there has been any change on the internal controls that have materially affected, or is reasonably likely to materially affect, the entity's internal controls over financial reporting. This does not imply, however, that the change is in response to an identified significant deficiency or material weakness.

> A registrant **may acquire a VIE**, subsequent to its fiscal year end.

Therefore, if a company is consolidating a VIE, which affects or is reasonably expected to affect its financial position materially, it should disclose the changes in its internal control in the first quarterly report that consolidates the VIE. It does not need to assess its evaluation of its newly consolidated entity's internal controls until the fiscal year end.

SOX requires that management assess and report on the effectiveness of internal controls over financial reporting as of the end of each fiscal year. Reporting requirements to comply with SOX are in Item 38 of the SEC's Regulation S-K. The SEC acknowledges overlap between disclosures of changes in internal controls over financial reporting and assessment of the effectiveness of internal controls. Changes affecting internal controls over financial reporting might occur subsequent to the end of fiscal year.



For example, a registrant may acquire a VIE, which has known material weaknesses in its internal controls, subsequent to its fiscal year-end. If management has knowledge about subsequent events that materially and adversely affect the effectiveness of the company's internal controls over financial reporting, it should disclose it in its assessment of effective internal controls. Paragraph 97 of AS 5 has a similar requirement for auditors to include an explanatory paragraph in their opinions regarding such events. CPA

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