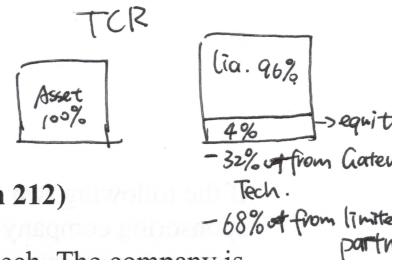


$$\frac{\text{Debt}}{\text{Asset}} = \frac{729 + 288}{900 + 300} = \frac{?}{1200 \text{ million}}$$

\uparrow 80% \uparrow 20%

Advanced Accounting--ACCT 401W
Writing Assignment #2

Due Date: Thursday, November 1, 2018 at 6:00 p.m. (Olin 212)



Assume you are currently working as an assistant controller with Gateway Tech. The company is in the final stages of setting up an entity called TCR Inc. in which Gateway Tech will own 32% of the limited partnership shares and passive investors will own the remaining 68% of the limited partnership shares. Gateway Tech will serve as the general partner for TCR and Gateway Tech employees will be running the operations of TCR. Only 4% of the financing will be provided by the partners; the remaining 96% of the financing will be provided by a single creditor (Mountain Capital) that will issue a long-term note payable. Gateway Tech will be guaranteeing all the debts for TCR. Specifically, if TCR cannot later pay its debts, Gateway Tech would have to step in and pay off any outstanding TCR debts.

The newly hired controller of your company (Katy Salerno) has indicated to you that this is the first entity of this type that Gateway Tech has ever set up. She is aware that your company needs to make a decision about whether it will need to either: (1) consolidate its financial statements with TCR or (2) apply the equity method to its 32% investment in TCR. Katy indicated that she only has limited experience with the financial reporting requirements for variable interest entities, but she believes that TCR is likely to be considered a variable interest entity under GAAP. She knows that the top management of Gateway Tech would like to avoid consolidation with TCR (because TCR will have so much leverage with 96% of its financing coming from creditors), but she is not sure if avoiding consolidation will be possible given the way that TCR is being set up. Furthermore, Katy has said that she is worried about the solvency of Gateway Tech if this deal goes through. Currently, Gateway Tech has \$729 million in liabilities and \$900 million in assets and TCR will have \$288 million in liabilities and \$300 million in assets.

Your assignment: Katy has asked you to write a memo to her [approximately two single-spaced pages in length] that will accomplish the following:

- (1) explain when variable interest entities need to be consolidated with their sponsoring company,
- (2) determine if the facts and circumstances associated with the establishment of TCR dictate that consolidation will be required (or can the equity method be employed) in order for Gateway Tech to be in compliance with GAAP, and
- (3) determine the debt to assets ratio for Gateway Tech (without consolidation) and what the company's debt to assets ratio will be if consolidation is required. Discuss the possible implication of this consolidation for the company's solvency given that Gateway Tech had \$22 million in cash provided by operations in the most recent fiscal year and TCR's expected operating cash flows are uncertain.

Note: You must do your own work. I will consider it plagiarism if your wording is similar to another student's wording (where a student modifies his or her memo based on the work of another student).

Summary of VIE GAAP Research

If the following two steps are met and (1) an entity is determined to be a VIE and (2) a sponsoring company is determined to be the primary beneficiary of the VIE, then the sponsoring company must consolidate its financial statements with its VIE.

Step 1: Identification of a VIE

VIEs are economic entities that cannot survive without the back up of subordinated financial support. This basic notion is supported by this FASB quote:

The Variable Interest Entities Subsections clarify the application of the General Subsections to certain legal entities in which equity investors do not have sufficient equity at risk for the legal entity to finance its activities without additional subordinated financial support (ASC 810-10-05-8)

The following two outcomes provide evidence that an entity cannot finance its activities without additional "subordinated financial support": (1) entity equity of less than 10% of its assets and (2) significant guarantees of entity debt by the sponsoring company.

Step 2: Identification of the Primary Beneficiary of the VIE

If an entity is deemed to be a VIE, the primary beneficiary needs to be determined. Two GAAP requirements must be met for an entity to be considered the primary beneficiary of the VIE. Here is what GAAP specifically says on this issue:

The reporting entity with a variable interest or interests that provide the reporting entity with a controlling financial interest in a variable interest entity (VIE) will have **both** of the following characteristics (per ASC 810-10- 05-8A):

- a. The power to direct the activities of a VIE that most significantly impact 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.

Note: To get additional GAAP information on the accounting for VIEs, you can type in FIN 46R and FASB 167 in a Google Search. Alternatively, you can go to the FASB Codification that pulls together all GAAP standards. At USD we have access to the FASB's database. USD students may log in at <http://www2.aaahq.org/ascLogin.cfm> using the following:

Username - AAA51546
Password - TS9f3Wn

If you have any questions about your FASB Online access, please contact marybeth.gripshover@aaahq.org or 941-556.4116. Once you get into the FASB web site there is a search engine where you can look for information on variable interest entities.

Format Issues

The heading for your memo should look something like this:

MEMO

TO: Katy Salerno
FROM: Your name
DATE: Today's date
SUBJECT: Variable Interest Entity Issues: TCR, Inc.

See the sample memo (included on pages 4-5 of this handout) for how to format and organize the content of a business memo.

For your memo use 12 point font and single spacing. Your memo should be approximately 2 pages. Double space between paragraphs and do not indent the first line of each paragraph. I suggest using subheadings to organize your memo.

I would try to avoid longer quotes from FASB Standards like FIN 46(R); but if you think that a longer quote is needed, you should mention the paragraph number of the FASB standard and indent the quote. For example, let's say that you wanted to quote part of Paragraph 9 from FIN 46(R). You would indent like this:

An equity investment at risk of less than 10 percent of the entity's total assets shall not be considered sufficient to permit the entity to finance its activities without subordinated financial support in addition to the equity investment unless the equity investment can be demonstrated to be sufficient. The demonstration that equity is sufficient may be based on either qualitative analysis or quantitative analysis or a combination of both.
[Paragraph 9--FIN 46(R).]

Note: I am more than happy to read early drafts of your memo during my office hours and make suggestions. I will also answer questions about this assignment by email, but I will not be able to "line edit" drafts of your memo sent to me via email.

MEMO

TO: Jennifer Pearson, Senior Vice President of Operations
FROM: Daniel Hege, Supply Chain Analyst
DATE: October 4, 2018
SUBJECT: Question of opening a new plant in Costa Rica

per yr request, you ask me to ... & review the VIE Cap. per my review,
What you want me to do
What I concluded
You asked our team to examine the possibility of opening a plant in Costa Rica. As you know, the idea originated because some of our customers have opened factories in Costa Rica in an area that is home to a number of medical device companies. These customers would like us to have a factory close to theirs so that we can deliver rapidly and remedy any quality issues quickly. We currently ship to these customers from our factory in South Carolina.

VIE two step model. evenian
I found VIE has two step.
We have looked at a number of factors, including customer requests, supply chain operations, and financial implications. Based on our analysis, we believe that personnel and financial constraints outweigh the cost savings and customer benefits of opening a new plant in Costa Rica. The following report details the information we analyzed that led us to this conclusion.

Customers *step 1: VIE identification.*

CAAP
Our customers are encouraging us to extend our global footprint. Opening a new plant in Costa Rica would respond to customer needs and reinforce our longstanding commitment to our customers. We now operate factories in the U.S., Mexico and China; a Costa Rica plant would give us another global location. We made the decisions to go into China and Mexico for similar reasons. Our first global plant was in Mexico, and we opened it in response to customers who had been in the country for a number of years and were looking for suppliers to co-locate. Our second global factory was in China; this one was partially in response to customer requests, but it was also in anticipation of our customers' likely expansion in China.

facts/ connect the dots
Costa Rica is similar to China in this way – some of our customers are there and are asking us to come, but they have small operations that they anticipate will grow over time. In spite of the fact that our customers express confidence in their long-term growth prospects in Costa Rica, we acknowledge that there is some risk that their forecasts for growth are too optimistic.

Financial Implications *Step 2: primary Beneficiary Identification*

CAAP
Capital is tight, and it would be a stretch to fund the new building without unacceptably high borrowing. We invested significant capital four years ago in China and six years ago in Mexico, and although those operations are profitable, the board may be reluctant to devote limited capital to another global factory.

Fact/ connect the dots
We analyzed the impact on corporate taxes of building the new plant. Current tax laws and trade agreements with Costa Rica suggest that there are no negative tax or trade consequences. Indeed, they may be favorable, although such agreements can change. Unlike China, where repatriating profits is costly, this is not true in Costa Rica. Therefore, we would have immediate access to all

the profits generated in that country. This money could be used for funding business growth at home and abroad, or for increasing our shareholder dividends.

Our team discussed the fact that any time we do business in another currency, we have to be mindful of currency exchange rate fluctuations. The Costa Rican Colon has been quite stable against the U.S. dollar for several years, so we are not particularly concerned about these fluctuations in the near term. Furthermore, it is possible to hedge the Colon and reduce the risk. However, as you know, our company is relatively small and has not used currency exchange rate hedging extensively in the past.

~~Supply Chain~~ — Debt to Asset Ratio.

As we looked at operations and the supply chain, we considered opening the plant, operating the plant, shipping costs, and personnel. Costs involved with opening the plant include purchasing the land, constructing the building, and buying and installing equipment. Leasing a building is also possible, but it is likely that we would incur significant costs fitting up the building for our use. We anticipate that plant operations would be very similar to those in our other factories, except that labor costs would be significantly lower than in the South Carolina plant. If we move some production to Costa Rica, the South Carolina plant will be underutilized for at least a year, which will increase the per unit production cost in South Carolina.

For shipping costs, we considered inbound shipping of materials, from our suppliers to the plant, and outbound shipping of our finished goods to our customers. Our inbound costs would increase slightly but our outbound costs would be significantly lower than shipping from South Carolina.

With regard to personnel, our supply chain and manufacturing personnel are being pushed to the limit with major quality issues in the Mexico plant and some ongoing startup challenges in China. We are very concerned that a new plant could result in serious quality degradation in Mexico and China.

Summary

Our team believes that, on balance, personnel and financial constraints outweigh the cost savings and customer benefits of opening a new plant in Costa Rica. We should, however, make it a priority to build customer confidence in this decision by assuring them that our service and quality performance will reflect our deep commitment to excellence if we continue producing in South Carolina.