Consolidation or Nonconsolidation of Variable Interest Entities: Ethical Dilemma Facing Newly Hired Controller

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Abstract

In this case, students take on the role of a newly hired controller (of a fictitious manufacturing company) who must interpret GAAP requirements with respect to the accounting for variable interest entities. The fictitious company is highly leveraged and has two large variable interest entities. The CEO and CFO of the company are determined to keep these entities off of the company's financial statements. The case requires critical thinking and judgment to determine if one or both of the company's variable interest entities must be consolidated according to current GAAP. Students need to determine if consolidation is likely to cause deterioration in the company's financial ratios resulting in a technical default on one or more debt covenants the company has with its long term lender. Students are to summarize their findings in a memo to the CEO and CFO of the company.

For this case, you are to play the role of the recently hired controller of Deluxe Seating, a leading manufacturer of custom seating for luxury cars. Previously you had worked as a manager at one of the Big 4 International Accounting Firms. Deluxe Seating had never been one of your clients. In fact, Deluxe Seating has not been audited by a Big 4 firm, but instead has been audited by a fairly good sized regional firm. You had found out about the Deluxe Seating controllership position from an executive search firm. This firm knew you were hoping to make the switch from public accounting to industry. Most of your public accounting experience had been with manufacturing clients and you felt you could make a significant contribution to the rapid growth of Deluxe Seating.

Just days after you accepted the position of controller at Deluxe Seating, the Company's Chief Financial Officer (CFO), Neil May, left his position to take a job as the Chief Executive Officer (CEO) of another company. When you arrived for your first day on the job at Deluxe Seating, you briefly met with the Company's CEO, Hal Wolfe, in the hallway and Mr. Wolfe told you that an executive search company was already at work to replace Mr. May's CFO position.

You spent most of your first day on the job reviewing financial statement information. Deluxe Seating has recently put together its (unaudited) financial statements for the year ended December 31, 2014. Additionally, you spent time reviewing documents related to the Company's variable interest entities (VIEs) provided to you by Assistant Controller, Sandra Ramirez. Ms. Ramirez said that Mr. May had been very eager to set up variable interest entities (VIEs) to help the company continue with its rapid growth. Ms. Ramirez gave you documents detailing the relationship between Deluxe Seating and its two primary VIEs: (1) Eagle, Inc. and (2) VPI Enterprises.

Variable Interest Entity #1—Eagle, Inc.:

Based on the documents provided by Ms. Ramirez, you determine that Eagle, Inc. was set up two years ago as a way to finance some major acquisitions of equipment that Deluxe Seating needed.

At the time, Deluxe Seating had the opportunity to buy $500 million in equipment and the company had explored different ways to finance this purchase. These options included issuing more common stock, debt instruments and/or preferred stock. After fully exploring these options, Deluxe Seating decided that none of these options were attractive and that some sort of off-balance sheet financing would be preferable. This off-balance sheet financing was made possible by creating a variable interest entity: Eagle, Inc.

While examining the VIE file, you read a memo discussing financing options written by former CFO, Neil May. With respect to the option of issuing more common stock, the following facts were considered: (1) Deluxe Seating's top corporate officers owned about 55% of the Company's common stock, (2) these owners did not have sufficient personal net worth to invest additional monies to purchase more common stock, and (3) top management was reluctant to issue shares to outside investors and risk losing control of the company.

Another option that Deluxe Seating explored was borrowing the $500 million needed to purchase the equipment. The main constraint with this approach was the restrictive debt covenants in the existing loan agreement Deluxe Seating had with its major lender: American Bank. These debt covenants specified various financial ratios that would trigger a technical violation of the debt covenant agreement between Deluxe Seating and American Bank. Upon any violation of the debt covenant agreement, the remaining $400 million principal from an existing note owed by Deluxe Seating to American Bank (due at maturity in 17 more years) would become due immediately. Ever since borrowing this money three years ago, Deluxe Seating has been very close to violating the debt to assets ratio debt covenant trigger. Deluxe Seating got into this problem by obtaining the aforementioned $400 million in debt financing from American Bank with Deluxe Seating agreeing to keep its debt to assets ratio below 80% to avoid triggering a violation of this debt covenant. When a debt covenant provision is violated, the long term debt is due on demand from the lender. At the most recent year end (December 31, 2014), Deluxe Seating had a debt to assets ratio of 78.7% and the company manages its cash flows and borrowings carefully so as to not default on the debt to assets ratio debt covenant (as well as the other financial ratio limits). American Bank would not be required to foreclose on the debt if Deluxe Seating ever violated one or more debt covenant restrictions, but the bank would have the option of foreclosure. Another option that American Bank would have (if a debt covenant was violated) would be to negotiate for a higher interest rate or perhaps American Bank might "force" Deluxe Seating to convert some of the debt owed American Bank by Deluxe Seating into common stock. In any respect, Deluxe Seating is highly motivated to avoid violating any of the debt covenants on its long-term debt borrowing. And since Deluxe Seating, as of December 31, 2014, has a debt to assets ratio that is very close to the 80% debt to assets ratio limit, this debt covenant provision creates an effective debt limit cap preventing Deluxe Seating from undertaking any significant new borrowing.

Another option that would be available to other companies (that is not available to Deluxe Seating) is issuing preferred stock. While the debt covenants in the agreement with American Bank do not preclude the issuance of preferred stock, per the debt agreement any issuance of preferred stock is considered to be debt for purposes of calculating the debt to assets ratio. Any future issuance of preferred stock would have to be a very small issuance considering how close Deluxe Seating is to violating the 80% debt to assets ratio loan covenant restriction.

Since issuing more debt or stock did not seem workable, Deluxe Seating sought financing for the needed $500 million equipment purchase through a variable interest entity. Here is how the plan worked: Deluxe Seating set up Eagle, Inc. as a corporation several years ago. Deluxe Seating leased the $500 million in equipment from Eagle, Inc. (setting up the transaction to meet the criteria to be treated as an operating lease on the books of Deluxe Seating). Eagle, Inc. obtained the $500 million in financing from two sources: (1) a $460 million loan from Central Capital Bank and (2) $40 million in equity capital. Several Deluxe Seating full-time employees work part of their workweek for Eagle, Inc. and the rest of the workweek for Deluxe Seating. All work done on behalf of Eagle, Inc. is performed at the headquarters of Deluxe Seating.

Eagle, Inc. is able to pay the interest (5% borrowing cost) and principal on the $460 million it borrowed from Central Capital Bank out of the $75.71 million annual rental revenue it receives from its lessee, Deluxe Seating, over the 6 year term of the noncancellable lease. The lessor and lessee assume an 8% implicit interest rate for the lease. The lessee must return the equipment back to the lessor at the end of the lease term and any residual value is not guaranteed. The estimated useful life of the equipment is 10 years. If for some reason Eagle, Inc. is not able to make its principal/interest payments to Central Capital Bank (due to Eagle, Inc. not receiving the required lease payments from Deluxe Seating), then Deluxe Seating would have a contingent obligation to pay any interest and principal that is owed by Eagle, Inc. to Central Capital Bank. In the past, Deluxe Seating has not booked a liability for this contingent obligation but has instead disclosed this contingent obligation in the footnotes of its financial statements. The footnote disclosure approach was used since Deluxe Seating top management did not think it was very likely that Eagle, Inc. would default on its payments to Central Capital Bank.

Eagle, Inc raised $40 million in equity capital. None of the top managers of Deluxe Seating own any of this stock. Eagle, Inc. does not have a board of directors and Deluxe Seating manages the business activities of Eagle, Inc. This activity is pretty limited and is controlled by the contractual terms in several agreements signed when the VIE was set up. Essentially, Deluxe Seating performs services for Eagle, Inc. as specified in three contracts: (1) the contract between Eagle, Inc. and its equity owners, (2) the debt contract between Eagle, Inc. and its lender, Central Capital Bank, and (3) the lease agreement between Deluxe Seating and Eagle, Inc.

Deluxe Seating does not have any contingent obligation to pay the owners of Eagle, Inc. (if for some reason Deluxe Seating is not able to make its lease payments). If Eagle, Inc. were to go into bankruptcy, Central Capital Bank would be paid first from the sale of the equipment leased by Deluxe Seating from Eagle, Inc. Any residual monies collected from this sale of equipment would go to the residual equity holders of Eagle, Inc. But in the happier scenario that Eagle, Inc. is profitable, its equity holders are guaranteed a 4% annual return on investment, with any Eagle, Inc. residual profits shared in the following ratio: Eagle, Inc. stockholders 55% and Deluxe Seating 45%. If Eagle, Inc. incurs any operating losses, these losses are to be absorbed by Deluxe Seating.

Deluxe Seating has treated its arrangement with Eagle, Inc. as a form of off-balance sheet financing. The financial statements of Eagle, Inc. have never been consolidated with those of Deluxe Seating. (**Note**: Eagle, Inc. has $460 million in long term debt and $40 million in equity as of December 31, 2014). Instead, Deluxe Seating top management has previously argued that

GAAP only required that the following information be footnote disclosed: (1) a schedule showing the future lease payments that Deluxe Seating will need to pay to Eagle, Inc. over the lease term (the lease is considered to be an operating lease with the leased property reverting back to the lessor at the end of the lease term when the leased property will likely still retain a significant unguaranteed residual value) and (2) the amount of the contingent obligation that Deluxe Seating would need to pay to Central Capital Bank, if Eagle, Inc. were to default on its loan with Central Capital Bank.

Variable Interest Entity #2—VPI Enterprises:
Deluxe Seating created a business several years ago called VPI Enterprises. This business has been treated as a VIE each year and VPI's financial statements have never been consolidated with Deluxe Seating's financial statements. VPI is organized as a limited partnership. Deluxe Seating serves as the general partner and owns 30% of VPI. The limited partners were granted, in the limited partnership agreement, kick-out rights that allow the limited partners to replace (or kick out) Deluxe Seating as the general partner of VPI. Per the partnership agreement, a three-fourth's (3/4) vote of the limited partners would be needed to kick out Deluxe Seating as the general partner. Per the partnership agreement, the general partner would need to be paid back twice its original capital contribution (by the limited partners) for the kick-out provisions to be effective. If the kick-out provisions ever became effective, Deluxe Seating would no longer be VPI's general partner or have any ownership interest in VPI.

The general partner runs the day-to-day operations of VPI and has unlimited liability to absorb any losses of VPI. The limited partners only have limited liability. These limited partners can lose their investment in VPI, but VPI's creditors have no right to take legal action against the personal assets of the limited partners to try to satisfy obligations of the partnership.

The limited partnership has a fairly inactive board. The board generally meets once a year for a short meeting. In the three years of VPI's existence, there have been no motions made to exercise the kick-out rights. The limited partners have voting rights that guarantee that they will control 70% of the board of directors' seats. The limited partners, per the limited partnership agreement, are to receive a 5% annual return on their investment. Once this threshold is reached, the general partner earns 65% of the excess profits and the limited partners earn 35%. None of the VPI limited partners are employees of Deluxe Seating or actually sit on Deluxe Seating's board of directors. Instead, the limited partners have (in the past) voted in a slate of outside board members recommended by the top management of Deluxe Seating.

During 2013, Deluxe Seating sold inventory with a cost of $4 million to VPI for $10 million (this $6 million in gross profit was included in the determination of Deluxe Seating's 2013 net income). While none of this inventory was sold by VPI to outside parties during 2013, in 2014 VPI was successful in selling half of the inventory to outside parties for $5.5 million, while the remaining half of the inventory (purchased from Deluxe Seating in 2013) was still in VPI's inventory as of December 31, 2014.

During 2014, Deluxe Seating sold inventory with a cost of $5 million to VPI for $12 million (this $7 million in gross profit was included in the determination of Deluxe Seating's 2014 net income). None of this inventory has been sold by VPI to outside parties as of December 31,

2014. The management of Deluxe Seating has asserted in the financial statements for 2013 and 2014 that the related party transactions between Deluxe Seating and VPI were at prices that are comparable to what Deluxe Seating would have received had it sold the inventory to unrelated 3rd parties.

While reviewing the material put together by Assistant Controller, Sandra Ramirez, you read several memos showing that the Company's former CFO and the Company's current CEO took the position that Deluxe Seating was not the primary beneficiary of VPI and therefore consolidation was not necessary. About 30% of the partnership shares of VPI are either owned by Deluxe Seating or are owned by Deluxe Seating top management (or former top management). The remaining shares are owned by limited partners. About 30% of the board seats have been held by Deluxe Seating top management, family members of Deluxe Seating's top management or former employees of Deluxe Seating.

The former CFO of Deluxe Seating, Neil May, had an integral part in setting up VPI and briefly served as CFO for VPI. Mr. May still maintains a seat on VPI's board of directors. Here are the financial statements for VPI for the last two years (the 2014 figures are unaudited):

Table 1: VPI Enterprises Income Statements. For the Years Ended December 31, 2013 and 2014

(Amounts in millions)

	2013	2014
Sales	$37.9	$39.1
Expenses	(42.3)	(44.9)
Net Income (Net Loss)	$(4.4)	$(5.8)

Table 2: VPI Enterprises Balance Sheets. December 31, 2013 and 2014

(Amounts are in millions)

	December 31, 2013	December 31, 2014
Cash	$1.4	$1.1
Other Current Assets	12.4	13.8
Noncurrent Assets	72.1	78.3
Total Assets	$85.9	$93.2

Current Liabilities	$2.2	$2.5
Noncurrent Liabilities	68.4	81.2
Contributions by Partners	11.0	11.0
Retained Earnings	4.3	(1.5)
Total Liabilities and Owners' Equity	$85.9	$93.2

Note: VPI had Cash Provided by Operations of $1.6 million and $1.3 million for the years ended December 31, 2013 and December 31, 2014, respectively.

You found in your review of the financial information on file that Deluxe Seating had guaranteed most of the long-term debt for VPI. Specifically, Deluxe Seating had guaranteed $55 million of VPI, Inc.'s noncurrent debt as of December 31, 2013 and $65 million of its noncurrent debt as of December 31, 2014. In Deluxe Seating's 2013 annual report, these contingent obligations are footnote disclosed. There is a similar footnote disclosure in the Company's unaudited December

31, 2014 financial statements. In these footnote disclosures, Deluxe Seating top management asserts that it is unlikely that Deluxe Seating would need to make any payments to VPI's creditors to satisfy any contingent obligations since VPI is on sound financial footing.

You note in your review that a medium sized regional public accounting firm, ABC LLP, has audited Deluxe Seating over the last two years (and is contracted to perform an audit of the Company's December 31, 2014 financial statements) and that both Deluxe Seating CEO, Hal Wolfe, and the partner in charge of the audit, Christine Eggers, are on the executive board for the School of Business of a local private university that has a strong accounting program.

You read a memo in the files from former CFO, Neil May, written 12 months ago to CEO, Hal Wolfe in which Mr. May complained that ABC LLP sent out an inexperienced audit senior for the Company's December 31, 2013 audit. This audit senior was questioning the accounting treatment of the Company's VIEs. Mr. May argued strongly that the VIEs were being handled correctly per GAAP. You read some additional memos that show that Deluxe Seating was successful in getting ABC LLP to reassign the original audit senior and send out a different audit senior for the December 31, 2013 Deluxe Seating audit. As previously mentioned, Deluxe Seating's financial statements for the year ended December 31, 2013 footnote disclosed the existence of its two main VIEs, but the Company did not consolidate its financial statements with its VIEs.

As part of your review, you come across a detailed memo written three months ago from Assistant Controller, Sandra Ramirez, to Brian Carver (the Deluxe Seating controller at that time), explaining her concerns about the Company's accounting treatment of its VIEs. (Ms. Ramirez was hired by Deluxe Seating a year ago.) Mr. Carver left his job at Deluxe Seating a month ago for a controllership position in a competing company. Mr. Carver had only worked at Deluxe Seating for eight months and there are no memos in the files in which Mr. Carver expresses any concerns he might have had about the accounting treatment of the variable interest entities. The only indication that Mr. Carver may have read the VIE memo written by Ms. Ramirez was the fact that he forwarded her email to the former CFO, Neil May. Shortly after receiving this forwarded email, Mr. May took a job with another company. Before leaving Deluxe Seating, Mr. May forwarded the aforementioned email to the Company's CEO, Hal Wolfe. Shortly after Mr. Wolfe received this email, Ms. Ramirez was invited to have lunch with Mr. Wolfe. Additionally, Ms. Ramirez left a memo in the files about a phone call she received from Mr. Wolfe in which he thanked her for her memo concerned with VIE issues. Mr. Wolfe mentioned during the phone call that he was eager to address her concerns, but since he knew little about technical accounting matters, he encouraged her to express her concerns to the newly hired controller.

At this point in your review, as the newly hired controller, you realize that you will need to put together a comprehensive memo that discusses current GAAP with respect to variable interest entities and links this GAAP discussion with the facts and circumstances associated with the two variable interest entities closely affiliated with Deluxe Seating. You will need to compose this well researched memo in order to support your recommendation with respect to the issue of consolidation or nonconsolidation of the two variable interest entities affiliated with Deluxe Seating.

Digging further through all the VIE related correspondence, you read a strongly written memo (written a month ago) from John Mullin who was the director of the treasury/finance department and is a CPA. Mr. Mullin expressed his strong belief that, in his professional opinion, Deluxe Seating's VIEs do not need to be consolidated. At the time he wrote the memo, Mr. Mullin was applying for the open CFO position.

As you continue reading through other material related to Deluxe Seating's VIEs, you glance at the inbox of your email program and you read an email from Mr. Wolfe congratulating Mr. Mullin for his promotion, effective immediately, to the position of chief financial officer. You barely finish reading the email when you receive a call from Mr. Mullin (your new boss). He says that he looks forward to working with you to continue the rapid growth and success of Deluxe Seating. You respond by congratulating him and say that you look forward to working with him as well.

After this phone call you become worried about how this variable entity issue is going to play out. You like the growth opportunity that working for Deluxe Seating provides. Furthermore, your salary is 15% more than that of other similar positions for which you interviewed in the months leading up to accepting the position at Deluxe Seating. You feel that you had done your due diligence by reading the Company's annual report before taking the job, but unfortunately the footnote disclosures concerning the company's variable interest entities were fairly obtuse and there had been no disclosures concerning the company's debt covenant restrictions since Deluxe Seating had never violated a debt covenant provision.

Once you finished reading the aforementioned memos concerned with Deluxe Seating's VIEs, you decide to review the relevant VIE related GAAP. Besides reading FASB Statements related to VIEs, you read a summary VIE GAAP memo put together by Ms. Ramirez. To put together her memo, Ms. Ramirez had reviewed relevant sections of ASC 810-10-05 (which reflects FIN 46R and FASB 167 and other GAAP associated with variable interest entities). Overall, her memo shows that there is a two-step process that must be followed with any VIE consolidation question:

Step 1: Determine if an entity is a VIE.
Step 2: If a VIE is identified in Step 1, then determine the primary beneficiary of that VIE. A company determined to be a VIE's primary beneficiary must consolidate its financial statements with its VIE's financials.

Below is a summary of the initial research conducted by Ms. Ramirez showing the two-step process needed to determine if it is necessary for a focal company to consolidate with an affiliated company that may or may not be deemed to be a VIE. (**Note:** In your role as Deluxe Seating's new controller in the case, you are likely to want to conduct some GAAP research beyond that provided by Ms. Ramirez).

Summary of Variable Interest Entity GAAP Research conducted by Ms. Ramirez:
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)

But what factors would suggest that an entity cannot survive without subordinated financial support? The following two outcomes seem to provide evidence (per my review of GAAP) that an entity cannot finance its activities without additional "subordinated financial support": (1) entity equity of less than 10% of assets and (2) significant guarantees of entity debt by the sponsoring company.
<u>or</u>,
Alternatively, Step 1 can be said to be met and a VIE can be said to exist if the entity equity holders do not really control the entity. This condition is met if:

As a group, the holders of the equity investment at risk lack any one of the following three characteristics **(per ASC 810-10-05-8):**

a. The power, through voting rights or similar rights, to direct the activities of a legal entity that most significantly impact the entity's economic performance,
b. The obligation to absorb the expected losses of the legal entity, or
c. The right to receive the expected residual returns of the legal entity.

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. According to GAAP, a primary beneficiary must have **<u>both</u>** 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.

Contingent Liability Issue:
After reading the memo by Ms. Ramirez, you realize that you will need to dig into VIE related GAAP at a deeper level than her VIE GAAP summary and you realize that you will also need to examine the issue of contingent liabilities. Currently, Deluxe Seating is simply footnote disclosing the extent to its loan guarantees as contingent liabilities. You wonder if Deluxe Seating's past approach of footnote disclosure is sufficient in this case. If you conclude (after conducting your research) that consolidation is necessary for both VIEs, then the aforementioned contingent obligations would need to be reflected in Deluxe Seating's consolidated balance sheet. On the other hand, if you eventually decide that Eagle, Inc. and/or VPI Enterprises do not need to be consolidated with Deluxe Seating, you realize that the contingent liability issue would need some additional attention. Only footnote disclosing the contingent obligations may not be sufficient. You decide you will need to look up the appropriate GAAP that outlines when contingent liabilities need to be included in the balance sheet (of the company providing the loan guarantee) and when footnote disclosure is sufficient.

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Deluxe Seating Financial Statements:
Below are the financial statements for Deluxe Seating for the last two years (the 2014 figures are unaudited):
Table 3: Deluxe Seating Income Statements. For the Years Ended December 31, 2013 and 2014
(Amounts in millions)

	2013	2014
Sales	$268.5	$302.0
Expenses	(233.4)	(276.2)
Net Income	$35.1	$25.8

Table 4: Deluxe Seating Balance Sheets. December 31, 2013 and 2014
(Amounts are in millions)

	December 31, 2013	December 31, 2014
Cash	$15.2	$12.4
Other Current Assets	100.8	119.1
Noncurrent Assets	650.9	746.8
Total Assets	$766.9	$878.3
Current Liabilities	$23.1	$28.4
Noncurrent Liabilities	582.3	662.9
Common Stock	40.0	40.0
Retained Earnings	121.2	147.0
Total Liabilities and Stockholders' Equity	$766.9	$878.3

Note: Deluxe Seating had Cash Provided by Operations of $50.2 million and $37.3 million for the years ended December 31, 2013 and December 31, 2014, respectively.

Case Requirements
Playing the role of the new controller of Deluxe Seating, write a memo to the Company's CEO, Hal Wolfe, (with a copy to Company's new CFO, John Mullin) that addresses the VIE issues that need to be resolved. Only provide quotes from FASB Statements when necessary. What is needed with this assignment is evidence of your critical thinking (and not an exercise in cutting and pasting from FASB Standards). Your memo needs to be very clear in its recommendations. Remember to consider any ethical issues that this case raises. Also remember, of course, to be tactful and professional in your business writing. At a minimum your memo should address the following issues:
Discussion Questions

1. Do you think there is sufficient evidence in this case to suggest that Deluxe Seating needs to consolidate its financial statements with Eagle, Inc.? Explain your reasoning.
2. Do you think there is sufficient evidence in this case to suggest that Deluxe Seating needs to consolidate its financial statements with VPI, Enterprises? Explain your reasoning and address the impact that the existence of kick-out rights has on your thinking.
3. Given your recommendation to have Deluxe Seating consolidate or not consolidate its financial statements with its VIEs, discuss how you think Deluxe Seating should account for its contingent obligation for its VIE's debts. Does ASC 450 (formerly FASB 5) concerned with contingent liabilities have any bearing on this case? If so, explain the implications of this standard on the accounting for the two VIEs in this case.

4. Compute the impact on Deluxe Seating's debt to assets ratio if: (1) Eagle, Inc. and/or VPI Enterprises need to be consolidated with its sponsoring company and/or (2) ASC 450 requirements dictate that Deluxe Seating needs to book contingent liabilities related to Eagle, Inc. and/or VPI Enterprises on its balance sheet. Assess the risk that Deluxe Seating will not be able to continue as a going concern if either Eagle, Inc. and/or VPI Enterprises defaulted on their loans.
5. Assess the likelihood that Deluxe Seating will violate its debt covenants (specifically the covenant concerned with its debt to assets ratio) with its major lender, American Bank. Discuss the implications of any possible future debt covenant violation and potential strategies for trying to get American Bank to renegotiate the debt covenants if default seems likely.
6. Do you agree with the approach Deluxe Seating has taken in accounting for its intercompany sales to VPI Enterprises? If you think these intercompany sales need to be accounted for differently, compute the impact of your suggested approach on Deluxe Seating's net income for the year ended December 31, 2014. (Ignore tax effects).
7. Are there any ethical issues in this case? What options are there for you (in your role as Deluxe Seating's newly hired controller) to consider if top management does not agree with your analysis with respect to the issue of consolidating or nonconsolidating the Company's VIEs?

Your primary focus in your memo should be on carefully linking VIE GAAP with the facts in the case to establish if Eagle, Inc. and/or VPI Enterprises need to be consolidated. To get GAAP information on the accounting for Variable Interest Entities 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. Once you get into the FASB web site there is a search engine where you can look for information on (1) variable interest entities, (2) related party transactions, and (3) contingent liabilities.

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