BACKGROUND

In December 20XX, the Financial Accounting Standards Board (FASB) issued FASB Interpretation No. 46 (revised December 20XX), *Consolidation of Variable Interest Entities* (FIN 46R), which addresses how a business enterprise should evaluate whether it has a controlling financial interest in an entity through a means other than voting rights and, accordingly should consolidate the variable interest entity (VIE). FIN 46R replaces FASB Interpretation No. 46, *Consolidation of Variable Interest Entities*, which was issued in January 20XX. The Company is required to apply FIN 46R to variable interests in VIEs created after December 31, 20XX. For variable interests in VIEs created before January 1, 20XX the Interpretation will be applied beginning on January 1, 20XX. For any VIEs that must be consolidated under FIN 46R that were created before January 1, 20XX, the assets, liabilities and noncontrolling interest of the VIE initially would be measured at their carrying amounts with any difference between the net amount added to the consolidated balance sheet and any previously recognized interest being recognized as the cumulative effect of an accounting change.

The following memorandum is XXXXX Management's analysis of FIN 46R's applicability to XXXXXXXXXXXXX (XXXXX) and YYYYYYYYYYYYYYYY (YYY). Extensive technical references have been used throughout this memorandum and were sourced from KPMG, PwC and Deloitte & Touche's accounting manuals on FIN 46R. Use of references and direct quotes from this literature have not been consistently footnoted or acknowledged as direct quotes in all instances for the sake of readability and expediency.

STEP 1 – DETERMINE IF FIN 46R APPLIES TO THE REPORTING ENTERPRISE(S)

XXXXX as the reporting enterprise will evaluate the following unconsolidated entities:

- ✓ AAAAAAAAAAA, (AAAAA)
- ✓ BBBBBBBBBB (BBB)
- ✓ CCCCCCCCCC (CCCC)

YYY as the reporting enterprise will evaluate its unconsolidated interest in XXXXX. All of the aforementioned entities were created prior to January 1, 20XX.

Scope of FIN 46R

FIN 46R is applicable to all entities with a list of exceptions from not-for-profit organizations to special purpose entities, as defined, to separate accounts of life insurance entities. Per review of FIN 46R, the only exception that warrants review in relation to XXXXX and YYY are the scope exceptions noted in Paragraph 4.h. as it applies to entities deemed to be a "business" under the definition of Appendix C:

> *4. h. …An entity that is deemed to be a **business** under the definition in Appendix C **need not be** evaluated by a reporting enterprise to determine if the entity is a variable interest entity under the requirements of this Interpretation **unless** one or more of the following conditions exist…*
> *(1) The reporting enterprise, its related parties, or both participated significantly in the design or redesign of the entity. However, this condition does not apply if the entity is an operating joint venture under joint control of the reporting enterprise and one or more independent parties or a franchisee.*
> *(2) The entity is designed so that substantially all of its activities either involve or are conducted on behalf of the reporting enterprise and its related parties.*
> *(3) The reporting enterprise and its related parties provide more than half of the total of the equity, subordinated debt, and other forms of subordinated financial support to the entity based on an analysis of the fair values of the interests in the entity.*

Appendix C states that an entity is deemed to be a business if it meets the following general criteria:

- ✓ Self-sustaining integrated set of activities and assets conducted and managed for the purpose of providing a return to investors.
- ✓ Consists of (a) inputs, (b) processes applied to those inputs, and (c) resulting outputs that are used to generate revenues.
- ✓ The elements necessary for a set to conduct normal operations will vary by industry and by the operating strategies of the set. An evaluation of the necessary elements should consider:
  - (a) Inputs
    - Long-lived assets, including intangible assets, or rights to the use of long-lived assets
    - Intellectual property
    - The ability to obtain access to necessary materials or rights
    - Employees
  - (b) Processes applied to those inputs - The existence of systems, standards, protocols, conventions, and rules that act to define the processes necessary for normal, self-sustaining operations, such as (1) strategic management processes, (2) operational processes, and (3) resource management processes.
  - (c) Resulting outputs that are used to generate revenues - The ability to obtain access to the customers that purchase the outputs of the set.
- ✓ Must contain all of the inputs and processes necessary for it to conduct normal operations, which include the ability to sustain a revenue stream by providing its outputs to customers.

Are Any of the Companies Eligible for the Scope Exception?

Based on the above, a reporting enterprise (XXXXX or YYY) must first determine whether each entity fits the definition of a "business" under the definition in Appendix C and then ascertain whether the "business" is eligible to be evaluated to determine if it is a variable interest entity.

XXXXXXXXXXXXX

Is it a business? - Based on the Appendix C factors, XXXXX appears to qualify as a business with long-lived and intangible assets (xxxxxxxxxxxxs, xxxxxxxxxxxx, etc) as well as employees in its offices in ZZZZZZ, ZZZZZZ and ZZZZZZ, informal strategic management, operational and resource management processes as well as resulting outputs and revenues.

Does it qualify under the Scope of FIN 46R? - Yes. Based on 4.h.(3), the reporting enterprise (YYY) and its related parties (GGGGGGGGGG, Inc. (GGG) and HHHHHHHHHHHH, Inc. a 50%-owned subsidiary of GGG) provide ALL of the members' capital (equity funding) and financial support for XXXXX.

AAAAAAAAAAA

Is it a business? - Based on the above factors, AAAAA is considered a business with long-lived and intangible assets (xxxxxxxxxxxxs, xxxxxxxxxxxx, etc) as well as its own employees, informal strategic management, operational and resource management processes as well as resulting outputs and revenues.

Does it qualify under the Scope of FIN 46R? - Based on 4.h.(3), it appears that AAAAA would qualify because the reporting enterprise, XXXXX, and its related parties are responsible for all the financial support of AAAAA.

BBBBBBBBBBBBB

Is it a business? - Based on the above factors, BBB is considered a business with long-lived and intangible assets (xxxxxxxxxxxxs, xxxxxxxxxx, etc) as well as employees via contracted labor, informal strategic management, operational and resource management processes as well as resulting outputs and revenues.

Does it qualify under the Scope of FIN 46R? - It is not completely clear, on the surface, whether BBB would qualify based on the criteria listed in 4.h.(1)-(3) because (a) it is a joint venture so (1) doesn't apply; (b) the entity is not designed so that substantially all of the activities are conducted on behalf of XXXXX; and (c) even though the terms of the venture agreement stipulate that XXXXX is to fund the acquisition of xxxxxxxxxxxx including xxxxxxxxxxxx, no funding has been provided to BBB by XXXXX and there are no active SSSSSSSSSSSSSS agreements requiring funding from XXXXX as noted in XXXXX's audited financial statements. Nonetheless, since XXXXX is obligated to provide all of BBB's financial support and since this is only a discussion of whether BBB qualifies for FIN-46R or VIE evaluation, we will conservatively assume that it does and will perform the evaluation.

CCCCCCCCCCCCCCCC Group
Is it a business? - Based on the above factors, it may be more difficult to ascertain whether CCCC would qualify as a standalone "business" because there are no employees, no active SSSSSSSSSSSSSSs or agreements, no offices, and XXXXX provides all the administrative services for CCCC. However, similar to BBBBBBBBBBBBB, the "employees" are via contracted labor through XXXXX. Because of the way the EEEEEEEEEE industry operates, it is possible to have a business with nothing more than a xxxxxxxxxxxx, a bank account and a company for hire to do all of your administration in exchange for a fee. Given that in this industry it is possible to operate a EEEEE company without the existence of physical space, employees, tangible "processes", etc, CCCC could still qualify as a "business". In addition, although it is not currently capitalized on CCCC's balance sheet, because current accounting rules do not allow it, CCCC also has a long-lived asset in its underlying EEEEEE which have been generated over time as contracted SSSSSSSSSSSSSSs wrote xxxxxxxxxxxx which were added to the repertoire of CCCC. This xxxxxxxxxxxx generates the revenues for CCCC and related xxxxxxxxxxxx expenses are paid to those SSSSSSSSSSSSSSs.

Section C6 of FIN 46R also mentions that "…if all but a de minimis (say, 3 percent) amount of the fair value of the set of activities and assets is represented by a single tangible or identifiable intangible asset, the concentration of value in the single asset is an indicator that an asset rather than a business is being evaluated…" Although a majority of the FMV would be allocated to CCCC's underlying xxxxxxxxxxxx, there are SSSSSSSSSSSSSS agreements that still have some value ascribed to them with a book value of $XXXXXXXXXXX and CCCC also has $XXXXXXXXXXXX in cash at June 30, 20XX. Since the $XXXXXXX in xxxxxxxxxxxx are backed by the xxxxxxxxxxxx, one may assume that all of the value should be ascribed to xxxxxxxxxxxx, however, assuming that in the case of CCCC, fair value approximates book value and given that XXXXX's investment in CCCC is $XXXXXXXX, then even the $XXXXXXXXXXX in cash constitutes more than 3% of the company's assets.

Based on the aforementioned, it appears that CCCC qualifies as a "business".

Does it qualify under the Scope of FIN 46R? - Note that effective June 15, 20XX, XXXXX, CCCC and CCCCCCCCCC entered into an assignment agreement whereby CCCC irrevocably sold, assigned, transferred and set over to XXXXX all of CCCC's assets.

Due to immateriality and for administrative ease, XXXXX accounted for CCCC as a joint venture up through June 30, 20XX resulting in an equity pickup of 100% of CCCC's income for the period or $XXXXXXXXXXXXXXXX for the 6 months then ended (note XXXXX picks up 100% of CCCC's income to the extent of former losses picked up by XXXXX as per the joint venture agreement).

XXXXX will record journal entries to record 100% of CCCC's assets and 3rd party liabilities as of June 30, 20XX and eliminate the investment in CCCC on XXXXX's books to take effect of the assignment agreement as of June 30.

Because the assets of CCCC will be consolidated into XXXXX as of June 30, 20XX, the only conflict appears to be whether we should consider making the consolidation effective as of Jan 1, 20XX or some period prior to June 30 because of FIN 46R (we assume CCCC qualifies under FIN 46R because XXXXX is required to provide all of the financial support to CCCC – see below).

If we were to consider earlier consolidation, the result on the P&L would be at most an increase in XXXXX's revenue of $XXXXXXXXXXXX and an increase in xxxxxxxxxxxx expense of $XXXXXXXX all of which is immaterial. There would be no impact on net income because XXXXX does an equity pickup of 100% of CCCC's results. Management feels that it would be unnecessary to perform a consolidation as of January 1, 20XX due to the immateriality of the venture's P&L results however, this is subject to the concurrence of the company's auditors.

Based on the above, all companies appear to be ineligible for a scope exception under FIN 46R.

STEP 2 – DETERMINE IF THE REPORTING ENTERPRISE(S) HAS A VARIABLE INTEREST

We have established that XXXXX, AAAAA, CCCC and BBB fall under the scope of FIN 46R. Now we must determine if YYY and XXXXX hold variable interests in these entities. A holder of a variable interest in an entity is required to determine whether the entity is a VIE and, if so whether it is required to consolidate the entity. A variable interest could be in the form of any equity investment, contractual arrangement or financing arrangement.

> *Paragraph 2(c) of FIN 46R states that variable interests are contractual, ownership, or other pecuniary interests in an entity that change with changes in the fair value of an entity's net assets exclusive of variable interests.*

A variable interest results from an economic arrangement that gives an enterprise the right to the economic risks and/or rewards of the entity or its "variability." A variable interest is a contractual arrangement or other agreement that **does not give rise to or create** variability in the fair value of the entity's net assets and operations; rather it **absorbs** or has rights to some or all of that variability. Changes in the fair value of most assets and operating liabilities create variability in the entity's net assets. Contractual arrangements or investments that do not create variability in the fair value of the entity are variable interests since the counterparty or investor **absorbs** the risks and rewards of the entity's activities.

Potential Variable Interests – Equity Investments

Paragraph 6 states that any interest that will absorb portions of a variable interest entity's expected losses or receive portions of the entity's expected residual returns are variable interests. Appendix B of FIN 46R refers to various examples of potential variable interests and in paragraph B7 it states that equity investments in a variable interest entity are variable interests to the extent they are at risk as defined by paragraph 5.

In the case of YYY and XXXXX (the investors), the most obvious possible variable interests are the investors' equity investments because the investors and or their related parties have provided capital and/or financial support to the entities (AAAAA, CCCC, BBB and XXXXX) and received an ownership interest that exposed the investors to potential losses and potential returns of the entities. Therefore the investors absorb the entities' expected losses and expected residual returns. There may be other variable interests that are applicable under FIN 46R however since a reporting enterprise only has to meet one of the criteria, we will use YYY and XXXXX's equity investments and determine if the equity investments are "at risk".

Are the equity investments "at risk"?

There are four conditions that the reporting enterprise must consider in order to conclude that the GAAP equity is at risk under FIN 46R:

Paragraph 5(a)(1) - Includes only equity investments in the entity that participate significantly in the profits and losses
Generally speaking, all of YYY and XXXXX's equity investments include investments in the entities that participate significantly in the profits and losses of the ventures/entities. As it relates to YYY and XXXXX and the related entities, there are no fixed dividends, guaranteed return of investments, residual value guarantees, put rights or anything that shield the investors from absorbing significant losses.

Paragraph 5(a)(2) – Does not include equity interests that the entity issued in exchange for subordinated interests in other variable interest entities
Consideration should be given to paragraph 5(a)(2) as it relates to YYY because as investor in XXXXX, they have effectively "funded" XXXXX's investments in AAAAA, CCCC and BBB which brings to question whether these entities should be considered VIE's in the context of YYY's reporting. However, paragraph 5(a)(2) states that equity at risk does not include equity interests that the entity issued in exchange for subordinated interests in other VIEs.

Furthermore, per PWC guidance, the objective of this provision is to ensure that a particular equity investment is not used to capitalize 2 entities (i.e., the equity investment should only count once). For Example if Enterprise X uses cash to capitalize Entity A and then uses its equity interest in Entity A to capitalize Entity B, the equity investment that Enterprise X holds in Entity B is not at risk because it was capitalized with a beneficial interest in Entity A. Therefore, one can conclude that YYY's beneficial interest in XXXXX is the only equity investment considered "at risk".

Paragraph 5(a)(3) – Does not include amounts provided to the equity investor directly or indirectly by the entity or by other parties involved with the entity (for example, by fees, charitable contributions or other payments), unless the provider is a parent, subsidiary, or affiliate of the investor that is required to be included in the same set of consolidated financial statements as the investor
PWC guidance states that an equity investment is not at risk if the cash or other assets used to make the investment was funded through fees. Stated differently, only an equity investor that has "skin in the game" is at risk. FIN 46R provides that fees paid either upfront or over time can result in a reduction in an investor's at risk equity. PWC guidance also suggests that the facts and circumstances must be evaluated to determine whether such fees are, in substance, a return of capital and thus reduce the amount of equity at risk. CCCC and AAAAA are both required to pay administration fees and interest on funding provided to the ventures by XXXXX. However because the administration fees and interest that are "paid" or charged to these companies represent either the fair value of administration services provided by XXXXX or a pass-through of XXXXX's cost of it's own funding, these fees and interest are not deemed a return of capital and do not serve to reduce the amount of equity at risk.

Paragraph 5(a)(4) – Does not include amounts financed for the equity investor (for example by loans or guarantees of loans) directly by the entity or by other parties involved with the entity unless that party is a parent, subsidiary, or affiliate of the investor that is required to be included in the same set of consolidated financial statements as the investor
This is not applicable as all of the financing came from XXXXX and YYY's parent companies. In other words, the burden of the investors to absorb potential losses of the entities was not decreased by loans or guarantees from the entities or other parties involved with the entities. Since XXXXX is included in the consolidated financials of YYY, the source of it's funding, this rule is not applicable. Same is true for YYY and GGG.

Based on the aforementioned, all of the equity investments appear to be "at risk" as defined, and therefore XXXXX and YYY have variable interests via their "at risk" equity investments in the entities.

STEP 3 – DETERMINE IF ENTITY IS A VARIABLE INTEREST ENTITY

We have established in the section above, that the holders of equity investments "at risk" are YYY as investor in XXXXX and XXXXX as investor in AAAAA, CCCC, and BBB. The next step in applying FIN 46R is assessing whether or not the entities, XXXXX, AAAAA, CCCC and BBB, are VIEs. As previously mentioned, the overall objective of FIN 46R is to identify those entities for which voting interests are not effective in determining whether the holder of voting interests or another party has a controlling financial interest in the entity.

Paragraph 6 states that the initial determination of whether an entity is a variable interest entity shall be made on the date at which an enterprise becomes involved with the entity. That determination shall be based on the circumstances on that date including future changes that are required in existing governing documents and existing contractual arrangements.

FIN 46R assumes that the voting equity holders do not have the "traditional" characteristics of control if the entity has **any one of the following characteristics**:

1. The entity is thinly capitalized (i.e. the equity is not sufficient to fund the entity's activities without subordinated financial support)
2. The equity holders as a group lack the rights to make significant decisions about the entity's activities
3. The equity holders as a group possess nonsubstantive voting rights
4. The equity holders as a group fail to absorb an entity's expected losses
5. The equity holders as a group fail to received the entity's expected residual returns

The first characteristic that must be assessed in determining whether and entity qualifies as a VIE focuses on the sufficiency of the VIE's equity. This assessment entails evaluating whether or not the equity is thinly capitalized; that is, whether the amount of equity is sufficient for the entity to finance its own activities. If the total equity investment at risk is insufficient the entity is a VIE. This condition is premised on the notion that if the total equity investment at risk is insufficient to finance an entity's activities, the parties providing the additional financing would restrict or even prohibit the equity investors from making decisions that are counter to their interests. Consequently, placing primary reliance on voting rights, as prescribed by the voting interest model, may result in flawed conclusions when determining which party holds a controlling financial interest.

FIN 46R includes a method for assessing the sufficiency of the equity investment at risk that is based on the potential negative variability in the returns of the entity—it's expected losses. The equity investment at risk must be large enough to absorb the potential downside variability of the entities activities in order to be sufficient. FIN 46R indicates that either a qualitative or quantitative analysis (or both) may be used to evaluate the sufficiency of the total equity investment at risk.

Paragraph 9 of FIN 46R states that the demonstration that equity is sufficient may be based on either qualitative analysis or quantitative analysis or a combination of both. Qualitative assessments, including but not limited to the qualitative assessments described in paragraphs 9(a) and 9(b) below, will in some cases be conclusive in determining that the entity's equity at risk is sufficient. If, after diligent effort, a reasonable conclusion about the sufficiency of the entity's equity at risk cannot be reached based solely on qualitative considerations, the quantitative analyses implied by paragraph 9(c) should be made. In instances in which neither a qualitative assessment nor a quantitative assessment, taken alone, is conclusive, the determination of whether the equity at risk is sufficient shall be based on a combination of qualitative and quantitative analyses.

a. The entity has demonstrated that it can finance its activities without additional subordinated financial support.

b. The entity has at least as much equity invested as other entities that hold only similar assets of similar quality in similar amounts and operate with no additional subordinated financial support.

c. The amount of equity invested in the entity exceeds the estimate of the entity's expected losses based on reasonable quantitative evidence.

PWC guidance states that "…Although the guidance in paragraph 9(a) of FIN 46 might appear easy to overcome, in reality it is often difficult to demonstrate the adequacy of the equity based on a qualitative assessment of the existing structure. For example, it is clear that numerous arrangements between reporting enterprises and an entity (or parties involved with the entity) can be variable interests…" PWC guidance also states that if an investor is obligated to fund an entity's activities on a continual basis, the entity would likely be a VIE (page 75). Page 146 of the PWC guidance specifically discusses joint ventures and mentions that many joint ventures are capitalized through stepped funding arrangements (equity or debt infusions) that occur over time, rather than at formation of the entity. As such, a thinly capitalized joint venture would not have sufficient equity at risk causing the entity to be a VIE.

AAAAAAAAAAA
The following qualitative factors should be considered in determining whether AAAAA is a VIE:

- ✓ The equity initially infused into the AAAAA venture represented the PPPPPPPPP (XXXXX paid $XXXXXXXXXXXXXXXXXM to purchase XXX% of the PPPPPPPPPPPP from RRRR and then contributed it's XXX% interest into the AAAAA venture). The contribution of this xxxxxxxxxxxx does not and did not provide sufficient cash flows to fund AAAAA's future activities. In addition, under the old venture agreement, XXXXX was required to absorb 100% of the losses of the venture. Previously allocated losses were first recoupable against any future profits then the profits were to be split XX/XX.

- ✓ In 20XX, XXXXX and PPPPPPPPPP entered into an Agreement whereby the companies contributed their XXX% interests into a division (AAAAA I) of AAAAAAAAAAA , a newly formed company. XXXXX then purchased an additional XX% membership interest in AAAAA I from PPPPPPPPPPPPP for $XXXXXXXXXXXXXX. After purchase of this additional membership interest in AAAAA I, the ownership interest and profit/loss ratio in AAAAA I changed from XX/XX to XX/XX. AAAAA II, a division of AAAAAAAAAAA , was also created for the purpose of housing contracts and assets purchased/developed after January 1, 20XX. AAAAA II was to be nominally capitalized by each of the members in a XX/XX ratio and each party will share in the profits and losses on a 50/50 basis. All contributions made to AAAAAAAAAAA and it's respective divisions were not sufficient to provide adequate cash flows to fund AAAAA's future activities.

- ✓ The members of AAAAA II never provided the nominal capital infusion in support of their membership interests in AAAAA II

- ✓ There are no future capital funding requirements by XXXXX and PPPPPPPPPPPPPP

- ✓ All of the aforementioned joint venture agreements stipulate(d) that XXXXX is/was to provide all funding for operations, signing of exclusive SSSSSSSSSSSSSs, as well as xxxxxxxxx and xxxxxxxxxxxx acquisitions.

Based on the aforementioned, it appears that AAAAA is "thinly capitalized" and the equity is not sufficient to fund AAAAA's activities without additional financial support which XXXXX is obligated to fund. In other words, XXXXX's equity investment at risk is not large enough to absorb the potential downside variability of AAAAA's activities and therefore AAAAA appears to be a VIE.

CCCCCCCCCCCCCCCCC Group
The following qualitative factors should be considered in determining whether CCCC is a VIE:

- ✓ At the initial formation of the venture, the venture agreements stipulated that XXXXX must provide all funding to the venture for operations, exclusive SSSSSSSSSSSSS xxxxxxxxxxxx, xxxxxxxxxxxx acquisitions, etc on a non-recourse basis.
- ✓ No capital was put into the venture
- ✓ As of June 30, 20XX, CCCC had no capital/equity and over $XXXXXXXXXXXXXXXXM in loans due to XXXXX for funding. These loans made by XXXXX to CCCC over time have been treated as "investments in CCCC" by XXXXX
- ✓ XXXXX is required to and has absorbed 100% of the losses of CCCC. Previously allocated losses are first recoupable against any future profits then the profits are to be split XX/XX.

Based on the aforementioned factors, it appears that CCCC's equity is not sufficient to fund it's activities without additional subordinated financial support all required to come from XXXXX. In other words, XXXXX's equity investment at risk is not large enough to absorb the potential downside variability of CCCC's activities and therefore CCCC appears to be a VIE.

BBBBBBBBBBBB
The following qualitative factors should be considered in determining whether BBB is a VIE:

- ✓ BBBBBBBBBBBB HHHHHHHHHHHH was formed on XXXXXXX as a joint venture between XXXXX and XXXXXXXXXXX on the one hand (BBB, respectively) and HHHHHHHHHHHH, Inc. on the other hand.
- ✓ The venture was formed pursuant to a Financing and Participation Agreement of the same date which called for HHHHHHHHHHHH, Inc. to provide financing for the venture activities in exchange for a XXX% worldwide interest in any BBB … xxxxxxxxxxxx.
- ✓ In 19XX, HHHHHHHHHHHH, Inc. assigned their interest in the venture to EEEEE (predecessor to XXXXX). At the time of assignment, EEEEEE (EEEE) recorded this investment at an approximate equity value of $XXXXXXXXXXXXXXXXX.
- ✓ XXXXX (and previously EEEE) has/had been accounting for BBB as a XX/XX joint venture since the assignment from HHHHHHHHHHHH for financial statement purposes.
- ✓ XXXXX assumed HHHHHHHHHHHH/EEEE's obligations to finance the joint acquisition of xxxxxxxxxxxx, xxxxxx, xxxx and reimbursement of direct out-of-pocket costs of administering the xxxxxxxxxxxx.
- ✓ Since the assignment, no additional funding or reimbursements have been requested by BBB and there are no active SSSSSSSSSSSSS agreements requiring additional financing as of June 30, 20XX.

Based on the above factors, it appears that the equity at risk could be considered sufficient to absorb the potential downside variability of BBB's activities because BBB has not required any additional funding from XXXXX or EEEE since assignment from HHHHHHHHHHHH in 19XX. *However*, Paragraph D31 of FIN 46 provides that "…the design of the entity and the apparent intentions of the parties that created the entity are important qualitative considerations. Often no single factor will be conclusive and the determination will be based on the preponderance of evidence…." Given this and the fact that the

BBB venture was originally designed such that HHHHHHHHHHHH/XXXXX/EEEE provide all the funding, once again, it appears that in substance, the BBB venture at formation mirrors that of CCCC and AAAAA (i.e. XXXXX and predecessors are the financiers who bore/bear all the financial risk and the venture partner(s) provides the creative talent without any infusion of capital or funding obligations). Further to that, upon review of BBB's 20XX tax return, it appears that on a tax basis, the profit and loss allocations as well as ownership positions are such that XXXXX is allocated 100% of losses and 98.08% of capital (see excerpt below).

Given the aforementioned, it appears that in substance, BBB qualifies as a VIE.

XXXXXXXXXXXXX

The following qualitative factors should be considered in determining whether XXXXX is a VIE:

- ✓ XXXXX commenced operations during 19XX pursuant to an Operating Agreement between three principal members: HHHHHHHHHHHH (USA) ("HHH"), Inc., YYY, each of which are affiliated with QQQQQQQQQQQ, and a group comprised of members of management.
- ✓ The company is run by a Management Committee consisting of XXX managers, each appointed by YYY, HHH and the management members, respectively.
- ✓ The Management Committee retains all voting rights and has responsibility for all of the day-to-day operations of the business and affairs of the Company.
- ✓ The original Operating Agreement called for QQQ, YYY and the management members collectively to each contribute a XXXX share of ordinary capital or a total of $XXXXXXXXXX each in exchange for a XXXXXX% interest in XXXXX.

- ✓ The original Operating Agreement also stipulated that QQQ and YYY would contribute $XXXXXXXXXXXX and $XXXXXXXXXXXXXXXX, respectively, in preferred capital.

- ✓ The Operating Agreement also provided that if the Management Committee, upon recommendation of the President and Chief Financial Officer of the Company, determined that the Company required funding after the full amount of the Preferred Capital Contributions had been made, the Management Committee could cause the Company to borrow from institutional financiers such sums, and on such terms and conditions (including terms that obligate the Company to grant liens on its assets in favor of the institutional financiers), as may be approved by the Management Committee. Each of QQQ and YYY were required, to the extent requested by the Management Committee, to provide guaranties of such loans from their respective credit worthy parent companies, on a several basis in proportion to their Preferred Capital Percentage, up to a maximum amount of US $XXXXXXXXXXXXX in the aggregate among both of QQQ and YYY. Such $XXXXXXXXXXXX was not to be construed as limiting the authority of XXXXX to obtain financing in excess of that sum.

- ✓ In 20XX/20XX, XXXXX required additional funding and requested that QQQ and YYY provide the guarantees as stipulated in the Operating Agreement. QQQ and YYY decided not to provide such guarantees and instead contributed additional preferred funding to XXXXXXXXXXXXXXXX. All told, from XXXX to 20XX, QQQ and YYY have provided $XXXXXXXXXXXXXX and $XXXXXXXXXXXXXXXX, respectively, to XXXXXXXX which is in excess of the original $XXXXXXXXXXXXX in aggregate funding as well as the additional $XXXXXXXXXXXXX in total anticipated loan guarantees contemplated in the original Operating Agreement.

- ✓ No Preferred Capital Contributions are required to be made by the management members

- ✓ The Company has the right to redeem, and the management members have the right to cause the Company to redeem, Ordinary Capital owned by management members (i) on or after January 1, 20XX, or (ii) if a management member ceases to be an employee of the Company. Ordinary Capital would be redeemed for an amount equal to the management member's share of the fair value of the Company's net assets at the redemption date subject to the terms of the Put/Call agreement.

- ✓ Losses are first allocated to Ordinary Members, then to Preferred Members and then to Special Ordinary Members. Profits are first allocated to Preferred Members and then to Ordinary Members, including Special Ordinary Members, in accordance with the terms of the Operating Agreement of the Company, as amended.

It appears that XXXXX could be considered a VIE as it relates to QQQ and YYY based on the following factors:

- ✓ PWC guidance again states that if an investor is obligated to fund an entity's activities on a continual basis, the entity would likely be a VIE (page 75). At original formation, it was anticipated that the original equity infusions provided to XXXXX would not be sufficient to support XXXXX's future activities. This is evidenced by section 2.3 of the xxxx operating agreement which states that QQQ/YYY were to provide loan guarantees of up to $XXXXXXXXXXXXX and XXXXX would not be precluded from obtaining outside financing if necessary subject to certain approvals.

- ✓ In addition, PWC's guidance states that the existence of guarantees of an entity's debt may indicate that the equity investment is not sufficient. For example, if a personal guarantee were necessary for the entity to receive financing from a 3rd party bank, the equity may not be sufficient. It is possible that XXXXX may have been able to obtain outside financing from a 3rd party bank without the guarantees from YYY or QQQ however XXXXX more than likely would have had to collateralize the loan by the company's then-existing xxxxxxxxxxx or future cash flow stream; it is highly unlikely that the preferred members would allow this to take place as it would potentially jeopardize their investment in XXXXX.

- ✓ XXXXX has obtained continued financing from QQQ and YYY since inception. Again originally anticipated funding and guarantees was $XXXXXXXXXXXXXX and actual funding totals $XXXXXXXXXXXXXXX at June 30, 20XX and $XXXXXXXXXXXXXXXXX at July 31, 20XX.

- ✓ The amount of funding required by the management members is minute by comparison to YYY and QQQ. Even though all losses are absorbed by the management members first, only $XXXXXXXXXXXX of their investment is available for absorption then all remaining losses are allocable to YYY and QQQ.

- ✓ The management members have the right to "put" their shares back to XXXXX based on a hypothetical calculation outlined in the Put/Call agreement.

- ✓ As mentioned earlier, Paragraph D31 of FIN 46 provides that "…the design of the entity and the apparent intentions of the parties that created the entity are important qualitative considersations. Often no single factor will be conclusive and the determination will be based on the preponderance of evidence…." It appears that once again that XXXXX's design is similar to that of the joint ventures whereby QQQ/YYY provide all the funding and the venture partner (management) provides the creative talent and day to day administration without any significant infusion of capital or future funding obligations.

Given the aforementioned, it appears that in substance, XXXXX qualifies as a VIE as YYY's equity investment at risk is not large enough to absorb the potential downside variability of XXXXX's activities.

STEP 4 – DETERMINE WHICH ENTERPRISE IS THE PRIMARY BENEFICIARY

We have established that the holders of equity investments "at risk" are YYY as investor in XXXXX and XXXXX as investor in AAAAA, CCCC, and BBB. In addition, we have established in the section above, that XXXXX, AAAAA, CCCC and BBB all appear to be variable interest entities. Now the reporting enterprises, XXXXX and YYY, must determine whether they are the primary beneficiaries and should consolidate the VIEs. In order to determine the primary beneficiary, the reporting enterprise(s) must take the following steps:

(a) Identify all other enterprises that hold variable interests in the VIE

(b) Combine its variable interests with all of the variable interests that are held by its related parties. Note that the primary beneficiary is the reporting enterprise (or related party group) with a variable interest(s) in the entity that is obligated to ***absorb the majority of the VIE's expected losses***.

Paragraphs 14-16 of FIN 46R state the following:

> ***Consolidation Based on Variable Interests***
> *14. An enterprise shall consolidate a variable interest entity if that enterprise has a variable interest (or combination of variable interests) that will absorb a majority of the entity's expected losses, receive a majority of the entity's expected residual returns, or both. An enterprise shall consider the rights and obligations conveyed by its variable interests and the relationship of its variable interests with variable interests held by other parties to determine whether its variable interests will absorb a majority of a variable interest entity's expected losses, receive a majority of the entity's expected residual returns, or both. If one enterprise will absorb a majority of a variable interest entity's expected losses and another enterprise will receive a majority of that entity's*

expected residual returns, the enterprise absorbing a majority of the losses shall consolidate the variable interest entity.

15. The enterprise that consolidates a variable interest entity is called the primary beneficiary of that entity. An enterprise shall determine whether it is the primary beneficiary of a variable interest entity at the time the enterprise becomes involved with the entity. An enterprise with an interest in a variable interest entity shall reconsider whether it is the primary beneficiary of the entity if the entity's governing documents or contractual arrangements are changed in a manner that reallocates between the existing primary beneficiary and other unrelated parties (a) the obligation to absorb the expected losses of the variable interest entity or (b) the right to receive the expected residual returns of the variable interest entity…

Related Parties
16. For purposes of determining whether it is the primary beneficiary of a variable interest entity, an enterprise with a variable interest shall treat variable interests in that same entity held by its related parties as its own interests. For purposes of this Interpretation, the term related parties includes those parties identified in FASB Statement No. 57, Related Party Disclosures, and certain other parties that are acting as de facto agents or de facto principals of the variable interest holder…

It should be noted that PWC guidance states that the FASB acknowledged that under FIN 46R, in many situations an entity may need to perform a quantitative analysis of the variable interests (i.e., a detailed computation of expected losses and expected residual returns) in order to identify the primary beneficiary. However the Board included the following comments in paragraph E35 of its basis for conclusions in FIN 46R:

…The proposed Interpretation would have required consolidation of a variable interest entity by an enterprise that provided significant financial support to that variable interest entity through a variable interest if that support was significantly more than the support provided by any other individual party. It also would have required consolidation by an enterprise that provided the majority of the financial support of a variable interest entity. Many respondents argued that an enterprise should consolidate a variable interest entity only if the enterprise provides a majority of the financial support to that entity. Some of those respondents stated that the reason was conceptual; others stated that the reason was practical, that is, it would be easier to apply a majority requirement. In some cases, the majority requirement will be applied qualitatively because the variable interests in an entity may be so different in nature that there is no common basis on which to compare them arithmetically. ***An enterprise may be able to determine without detailed computations that it does not have a sufficiently large variable interest to be a potential primary beneficiary or that it is the only enterprise with a sufficiently large interest. In other cases, an enterprise may know that it is one of only a few potential primary beneficiaries and may need to apply judgment to determine whether it meets the conditions to be a primary beneficiary.***

PWC further states (page 107) that "…the FASB believes that in many circumstances, a reporting enterprise will be able to rely on qualitative factors to identify the primary beneficiary. In certain situations, the determination of who is the primary beneficiary appears straightforward and a qualitative analysis will suffice…" PWC also states that they believe "…a reporting enterprise should document the evidence available to support the qualitative decision as to whether an entity is the primary beneficiary of a VIE. For example, a reporting enterprise may have data that supports its assertion that the VIE's losses are absorbed by (and have historically been supported) the reporting enterprise on a first-dollar basis and that the obligations of the other variable interest holders in the VIE are so small in relation to the evaluating enterprise's interest, that there is only a remote chance that other parties would absorb any of the VIE's expected losses…"

CCCCCCCCCCCCCCCC Group and BBBBBBBBBBBB
In the case of XXXXX as the reporting enterprise, it has been established that XXXXX is required to absorb the majority of the expected losses of CCCC and BBB (based on tax return). Thus XXXXX appears to be the primary beneficiary in CCCC and BBB.

AAAAAAAAAAA
XXXXX has been and is required to absorb the majority of the losses of AAAAA I with a current xxx% interest in AAAAA I. In the previous formation of AAAAA, XXXXX was required to absorb xxx% of the losses. Hence AAAAA I was already eligible for consolidation under existing accounting rules. However, as KPMG noted at 12/31/XX, AAAAAAAAAAA is one legal entity with different classes of membership interest for profit/loss tracking purposes and it would be inappropriate to bifurcate the joint venture and partially consolidate AAAAA I. XXXXX appears to be the primary beneficiary in AAAAA I however, we have to evaluate whether XXXXX is also the primary beneficiary of losses in AAAAA II because of the bifurcation issue.

Considering that PPPPPPPP is not required to provide any capital or funding to AAAAA II outside of a nominal amount (i.e., PPPPPPPPPPP has no "at risk" capital in AAAAA II) and that XXXXX has both debt invested and all the future funding obligations in AAAAA II, it appears that XXXXX is the primary beneficiary and is obligated to absorb the majority of the losses of AAAAA II. One may try to argue that some of XXXXX's risk is partially offset by the fact that XXXXX is entitled to receive interest payments from AAAAA on the outstanding loan funding at the rate of XX% per annum. However the payments of interest are also only payable to the extent that AAAAA has monies available to repay the interest back to XXXXX (in essence XXXXX has to fund repayments of interest as well until AAAAA becomes profitable). Thus, the provision for repayment of interest does not preclude XXXXX from being the primary beneficiary in AAAAA II.

Based on the aforementioned, XXXXX appears to be the primary beneficiary in AAAAAAAAAAA . This assessment is consistent with KPMG's and PWC's conclusion that XXXXX is required to pick up 100% of AAAAA II's losses prior to adoption of FIN 46R.

XXXXXXXXXXXXX
As of June 30, 20XX, QQQ and YYY had invested $XXXXXXXXXXXXXXXXX and $XXXXXXXXXXXXX in preferred capital, respectively. As of July 31, 20XX, QQQ and YYY had both equally invested $XXXXXXXXXXX each in preferred capital. In accordance with FAS 57, XXXXXX's parent companies, YYY and QQQ, would be considered related parties because of their common owners/parent companies (see chart below). GGGGGGGGGG, Inc. owns 100% of YYY and xxx% of HHHHHHHHHHHH, Inc. who owns xxx% of HHHHHHHHHHHH (USA). In addition, TTTTTTTTTTTT owns significant portions of both QQQ and HHHHHHHHHHHH, Inc.

So the question is which company, YYY or QQQ should be considered the primary beneficiary in XXXXX?

Paragraph 17 of FIN 46R states the following:

> *If two or more related parties (including the de facto agents described in paragraph 16) hold variable interests in the same variable interest entity, and the aggregate variable interest held by those parties would, if held by a single party, identify that party as the primary beneficiary, then the party, within the related party group, that is most closely associated with the variable interest entity is the primary beneficiary. The determination of which party within the related party group is most closely associated with the variable interest entity requires judgment and shall be based on an analysis of all relevant facts and circumstances, including:*
>
> a. *The existence of a principal-agency relationship between parties within the related party group*
> b. *The relationship and significance of the activities of the variable interest entity to the various parties within the related party group*
> c. *A party's exposure to the expected losses of the variable interest entity*
> d. *The design of the variable interest entity.*

Principal-Agency relationship – it does not appear that one member of the related party group is acting in the capacity of an agent of another member of the related party group. At the YYY level, YYY and HHHHHHHHHHHH (USA) are acting as "agents" for GGGGGGGGGG and HHHHHHHHHHHH, Inc., respectively.

Relationship and significant activity – YYY and QQQ are US "holding" companies with no employees or physical office space. YYY's books and records and treasury management functions are provided by Corporate Management Group. XXXXX provides accounting, bookkeeping, treasury management (bank account maintenance), financial reporting, recordkeeping, liaison services with HHHHHHHHHHHH, Inc, tax preparation, and other administrative services to QQQQ. In addition, if one were to extend this analysis up one level to the parent companies of YYY and QQQQ, HHHHHHHHHHHH is the exclusive RRRR of XXXXX's xxxxxxxxxxxx in ZZZZZZ and other markets (similar to XXXX in other parts of the world) and XXXXX is the exclusive RRRRRR of HHHHHHHHHHHH's xxxxxxxxxxxx in the U.S. whereas no such relationship exists between NNNNNN and XXXXX. HHHHHHHHHHHH is not significantly dependent on XXXXX as a supply/distribution source however a closer relationship exists at a business activity level between XXXXX and HHHHHHHHHHHH.

Parties Exposure to the expected losses of the VIE — When analyzing this indicator, consideration should be given toward the member of the related party group that absorbs the largest portion of the entity's expected losses.

At initial formation more losses were allocable to QQQQQ than YYY based on the relative contributions of preferred capital (QQQQ contributed $XXXXXXXXXXXXX and YYY contributed $XXXXXXXXXXX). On a cumulative basis, as of December 31, 20XX YYY had been allocated $XXXXXXXXXXXXXXXM in losses whereas QQQ had been allocated $XXXXXXXXXXXXX in losses. As the losses were absorbed first by QQQ in greater proportion and because the profit/loss allocation ratios are reset at the end of each period, over time, the percentage of losses allocable to YYY increased to which YYY's allocation rate at December 31, 20XX exceeded the loss allocation rate of QQQ.

Based on the members' equity calculation performed at December 31, 20XX, YYY was allocated XX% of XXXXX's losses whereas HHHHHHHHHHHH was allocated XX% of the losses. Additionally note that YYY and QQq have invested an additional $XXXXXXXX and $XXXXXXXXXXXX, respectively, in July 20XX which will mean that a higher percentage of losses will be allocated to YYY in the future.

However, XXXXX's annual losses are expected to decrease based on the company's projections and therefore the amount of losses YYY will be exposed to in the future will be smaller than those previously absorbed.

Thus it appears that QQQ is the member of the related party group that absorbs the largest portion of the entity's expected losses.

Design of the VIE – When evaluating this indicator, reporting enterprises should focus on the structure of the VIE in an attempt to identify the appropriate primary beneficiary. There may be instances where it is clear that an entity was designed or structured for the benefit of one member of the related party group. While the design gives no indication of who is the primary beneficiary at the YYY/QQQ level, if one were to extend this up to the parent company level, NNNN as XX% owner of YYY and XX% owner of HHHHHHHHHHHH (100% parent of QQQ) would absorb a majority of XXXXX's losses. However, since the ZZZZZZ parent companies of QQQ and YYY are not subject to the rules and provisions of FIN 46R, it is not necessary to evaluate the extent of loss exposure these companies have as it relates to XXXXX.

Although it is not 100% clear cut, management has tentatively concluded based on the factors above, that YYY is **not** the primary beneficiary in the related party group however, it would be prudent to consult with YYY's management and auditors to obtain concurrence with this viewpoint.

CONCLUSION

The results of management's FIN 46R analysis are summarized in the following table:

In sum, XXXXX's Management concludes that XXXXX, AAAAA, CCCC and BBB are all variable interest entities and that XXXXX is required to consolidate AAAAA, CCCC and BBBBBBBBBBBBB. XXXXX's management also concludes that XXXXX is a VIE however HHHHHHHHHHHH (USA) appears to be the primary beneficiary in the related party group. It would be prudent to consult with YYY's management and XXXXXX to obtain concurrence with this viewpoint.