

## Case 14-1

### Bringing Students Together

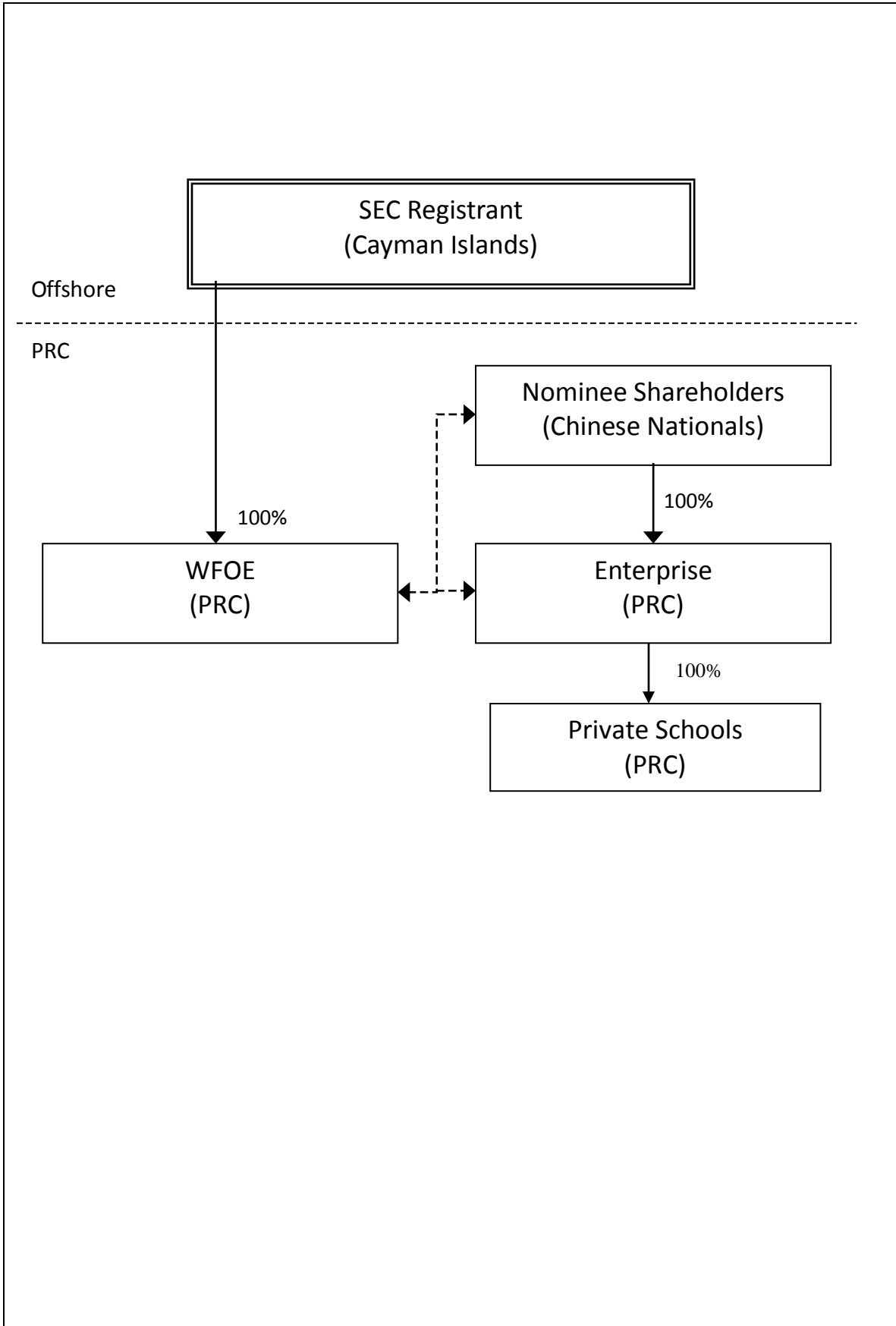
#### *Overview*

Education in China is highly protected by the government of the People's Republic of China (PRC) because it represents an avenue to teach, inform, and shape the minds and beliefs of the country's people. As a result, any enterprise that provides education services in China needs to follow certain PRC laws. Specifically, one law requires that an entity that conducts education services must be owned by Chinese nationals and cannot be owned directly by foreign individuals or entities.

Recently, an increasing number of wholly foreign-owned enterprises (WFOEs) in the PRC are involved in complex business structures that allow a foreign entity (often an SEC registrant), through a series of contractual arrangements as opposed to equity ownership, to effectively control a PRC-domiciled enterprise that provides education services. This typically results in the SEC registrant accounting for the PRC-domiciled education enterprise as a consolidated subsidiary, effectively allowing the SEC registrant to recognize the gross assets, liabilities, and profits (or losses) of the PRC enterprise even though the WFOE has no equity ownership. These structures have been the subject of recent public scrutiny and focused on by the SEC. This case will discuss (1) the various contractual agreements that are used to create such structures and (2) whether a consolidation conclusion is appropriate under U.S. GAAP in different scenarios.

#### *Background*

Six Chinese nationals (the Nominee Shareholders) form a business enterprise (the Enterprise) in the PRC that will own and operate private schools. The Nominee Shareholders will own 100 percent of the equity in the Enterprise, each with an equally proportionate ownership interest. The Nominee Shareholders are related parties. The Enterprise secures and maintains the government-required licenses and permits to operate private schools in the PRC. A foreign entity (the SEC registrant) is domiciled in the Cayman Islands and establishes a WFOE domiciled in the PRC. The WFOE develops and maintains all of the intellectual property and provides employees, resources, and other services to run the schools. See the simple organization chart below.



In the chart above, the dotted lines represent various contractual arrangements that are the subject of this case to determine whether those contractual arrangements will (1) result in the Enterprise qualifying as a variable interest entity (VIE) and (2) allow the WFOE (and therefore the SEC registrant) to consolidate the Enterprise.

*Equity pledge agreement* — The WFOE and Nominee Shareholders enter into an agreement whereby the Nominee Shareholders pledge their equity interests in the Enterprise to the WFOE to secure and protect the WFOE from incurring economic losses in the event the Enterprise does not fulfill its obligation to pay to the WFOE service fees according to the terms of the management service agreement. The agreement prevents the Nominee Shareholders from selling, transferring, or encumbering their equity ownership interest in the Enterprise without the consent of the WFOE. In addition, the agreement prevents the Enterprise from declaring a dividend or initiating a liquidation. This agreement protects the WFOE against possible unauthorized transfers of equity or assets by the Nominee Shareholders and attempts to further protect the WFOE by maintaining the assets of the Enterprise unencumbered.

*Call option* — The WFOE and Nominee Shareholders enter into an agreement whereby the WFOE has the exclusive and irrevocable right to cause the Nominee Shareholders to transfer to the WFOE all or part of their equity ownership interests in the Enterprise at any time for either (1) the lowest amount permissible under PRC law or (2) the original capital contribution amount. The exercisability of this contract is questionable since there are foreign ownership restrictions in current PRC law and the WFOE is foreign owned.

*Management service agreement* — The WFOE and Nominee Shareholders enter into an agreement that specifies the services that the WFOE will provide to the Enterprise. Services will be provided to the Enterprise exclusively by the WFOE. The WFOE has the exclusive right to provide the intellectual property, employees, resources, and other services for the Enterprise's schools. The Enterprise pays service fees to the WFOE for its use of the WFOE's intellectual property and other services provided by the WFOE. These service fees are significant, can be adjusted at any time at the sole discretion of the WFOE, and are not subject to minimum or maximum amounts. The annual service fee amounts to substantially all of the net income of the Enterprise and effectively serves as the mechanism for the earnings of the Enterprise to be extracted by the WFOE. The Nominee Shareholders cannot terminate the agreement except for cause (i.e., breach of contract, law). Some of the provisions of the management service agreement, as stated above, are not customarily present in arrangements for similar services negotiated at arm's length.

The Nominee Shareholders will agree to enter into these arrangements in exchange for an equity ownership in the SEC registrant commensurate with that in the Enterprise.

The business of the Enterprise (including the activities that have the most significant impact on the economic performance of the Enterprise) is managed by the Enterprise's board of directors, which is composed of the Nominee Shareholders. The Enterprise's senior management team reports directly to the board of directors and has the authority to

lead the business operations, implement the decisions and plans adopted by the board of directors, and is subject to dismissal by the board of directors with or without cause.

***Question 1***

Is the Enterprise a VIE as defined in the ASC Master Glossary? If so, what criteria cause it to be deemed a VIE? Assume that (1) the Enterprise does not qualify for any scope exceptions and (2) the equity investment by the Nominee Shareholders in the Enterprise represents equity investment at risk.

***Question 2***

If the Enterprise is deemed to be a VIE, would the WFOE (excluding any related party or de facto agency relationships) consolidate the Enterprise?

***Additional Facts 1***

The WFOE and the Nominee Shareholders enter into an additional contractual agreement:

*Power of attorney* — The WFOE and Nominee Shareholders enter into an agreement that provides the WFOE with irrevocable power of attorney (POA) over the Nominee Shareholders with regard to their interests in the Enterprise. According to the POA, the Nominee Shareholders assign the WFOE (or any person designated by WFOE) as their attorney-in-fact to vote on their behalf on all matters of the Enterprise requiring shareholder approval under PRC laws and regulations as well as all matters requiring a vote by the board of directors. This ensures that the Nominee Shareholders will act at the direction of and in the best interest of the WFOE.

***Question 3***

What impact, if any, does the POA agreement have on the conclusion reached in Question 2?

***IFRS Addendum***

Does the accounting analysis or conclusion change for each of the questions above when analyzed in accordance with IFRSs?