A Roadmap to Consolidation
Identifying a Controlling Financial Interest
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Preface

July 2020

To the clients, friends, and people of Deloitte:

We are pleased to present the 2020 edition of A Roadmap to Consolidation — Identifying a Controlling Financial Interest. This publication is a comprehensive guide to navigating the frequently complex consolidation accounting models. Appendix J summarizes the changes made to this Roadmap since the issuance of the 2019 edition.

The Roadmap breaks down the requirements in ASC 810\(^1\) and reconstructs them in a logical narrative, making them easier to understand and apply. While the discussion focuses primarily on the complexities of identifying whether a legal entity is a variable interest entity (VIE) and whether a reporting entity should consolidate the VIE, it also addresses the voting interest entity model and provides a framework for its application.

At the beginning of several of the Roadmap’s chapters, we have included a small flowchart that, when clicked, opens a larger version that contains links to each step of the consolidation analysis. If you get lost when performing the analysis, we recommend grounding yourself by going back to the flowchart at the end of the Introduction. (Believe us, it can be easy to lose your way!)

We encourage you to use this Roadmap as a guide throughout your application of the consolidation guidance. However, the Roadmap is not a substitute for consulting with Deloitte professionals on complex accounting questions and transactions.

Subscribers to the Deloitte Accounting Research Tool (DART) may access any interim updates to this publication by selecting the Roadmap from the Roadmap Series page on DART. If a “Summary of Changes Since Issuance” displays, subscribers can view those changes by clicking the related links or by opening the “active” version of the Roadmap.

We hope that you find this publication a valuable resource, and we welcome your suggestions for improvements as new chapters in the consolidation story unfold.

Sincerely,

Deloitte & Touche LLP

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\(^1\) For a list of the titles of standards and other literature referred to in this publication, see Appendix H. For a list of abbreviations used in this publication, see Appendix I.
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The Evolution Story

After more than four decades of little change, the accounting guidance on consolidation began to evolve rapidly in the early 2000s. Changes have included the creation and almost immediate amendment of the VIE model, major overhauls of the initial VIE model, and several updates to the consolidation framework for limited partnerships (or similar entities). The timeline below provides an overview of these and other key events.

The significant events are explained in the sections below, along with discussions of whether the related guidance and concepts continued to evolve, changed into new concepts, or became extinct as a result of subsequent amendments.
ARB 51 (Survived and Evolved Into the Voting Interest Entity Model)

ARB 51 (issued in 1959) established a presumption that consolidated financial statements are more meaningful than separate statements when a reporting entity directly or indirectly has a controlling financial interest in another legal entity. The ARB 51 model, later codified in ASC 810 and referred to in this Roadmap as the voting interest entity model, has survived with some modifications over the years. Under the evolved model, control is presumed by the holder of a majority voting interest unless noncontrolling shareholders have substantive participating rights. For companies with simple capital structures or in which voting interests are held through a legal entity’s equity, the model results in a meaningful consolidation conclusion. However, the model’s survival has been threatened by external factors and the development of more complicated capital structures over the last half century. Although the model has thus far survived, the standard setters have continued to amend it over the years, and in January 2003, they developed the VIE model to address these concerns.

SOP 78-9 (Extinct)

SOP 78-9 required general partners of limited partnerships to consolidate the limited partnership unless the limited partners had “important rights” such as the right to replace the general partner or partners, approve the sale or refinancing of principal assets, or approve the acquisition of principal partnership assets. Since there was very little authoritative guidance on assessing whether a limited partner’s rights were “important rights,” views varied about what constituted such rights. The guidance was eventually clarified but later rescinded in EITF 04-5, as discussed below.

Statement 94 (Survived)

Among other changes, Statement 94 eliminated the “non-homogeneity” exception in ARB 51 that was used by companies as a reason to not consolidate majority owned (or wholly owned) subsidiaries on the basis that the subsidiary’s character was different from that of the parent. Subsidiaries most commonly not consolidated on this basis included finance, insurance, real estate, and leasing subsidiaries of manufacturing and merchandising enterprises. Since the issuance of Statement 94, a subsidiary must be consolidated, regardless of whether the subsidiary’s and parent’s operations are homogenous.

Special-Purpose Entities — Various EITF Issues (Extinct)

From 1989 to 1996, in reaction to various structures designed to achieve off-balance-sheet treatment as well as the proliferation of special-purpose entities (SPEs) and securitizations, the EITF addressed several issues related to SPEs. For example, it reached consensuses on EITF 90-15 (certain leasing transactions), EITF 95-6 (accounting by a REIT for an investment in a service corporation), EITF 96-21 (leasing transactions involving SPEs), and the SEC observer comments in Topic D-14 that addressed SPEs. Despite these targeted improvements to the consolidation guidance, transactions were frequently structured in a manner that would achieve continued off-balance-sheet treatment. As a result, and in reaction to these concerns, the FASB issued FIN 46 in 2003 (see discussion below), which superseded the consolidation provisions in these EITF issues.

EITF 96-16 (Survived and Incorporated Into the Voting Interest Entity Model)

Before the issuance of EITF 96-16, there were no criteria under the consolidation requirements for determining whether control rested with a majority voting interest if certain rights were granted to the minority shareholder. The consensus in EITF 96-16 was that the rights of a minority shareholder should overcome the presumption of consolidation by the majority owner if those rights, individually or in the aggregate, give the minority shareholder the ability to effectively participate in significant decisions that would be expected to be made in the “ordinary course of business” (referred to as substantive
participating rights). The concepts in EITF 96-16 have survived the subsequent amendments to the consolidation requirements and have been codified in ASC 810’s voting interest entity model.

FIN 46 and FIN 46(R) (New Species — Evolved Several Times Since Issuance and Many Concepts Remain)

In the late 1990s and early 2000s, companies began structuring entities to separate economics from voting rights and thereby avoid consolidation under the voting interest entity model. The Enron scandal began to unfold in October 2001, and the subsequent congressional hearings in 2002 accelerated the creation of a new consolidation species — the VIE. The FASB issued FIN 46 in early 2003 after an extremely short time deliberating such a fundamental change to the consolidation landscape. One may argue that many of the complex concepts in today’s VIE model were born of the desire to quickly “fix” the gap in the consolidation framework that permitted SPEs to remain off balance sheet. For example, the VIE concept ended up applying to many more entities than the abusive SPEs it was intended to address, including many operating entities. Given these complexities, the FASB (by the end of 2003) had issued eight staff interpretations and a revised version of the new guidance (FIN 46(R)).

The VIE concept as created by FIN 46 (and subsequently amended by FIN 46(R)) requires reporting entities to identify a “controlling financial interest” on the basis of which party, if any, is exposed to a majority of the risks or rewards of the legal entity. Given the design of a VIE, an analysis of voting rights was not viewed as an effective way to determine whether an enterprise has a controlling financial interest in that legal entity, and exposure to a majority of the risks and rewards became the proxy for identifying control for a VIE. That is, at the time, the FASB questioned whether an investor would accept a majority of the exposure to a VIE without being able to control the decisions. Frequently, a subjective and complex calculation needed to be performed of the expected losses and expected residual returns of the VIE. As a result, during the FIN 46(R) era, a reporting entity with neither stated nor implied power often ended up consolidating a VIE. In addition, in an effort to curtail perceived structuring through related parties, the FASB expanded the list of related parties that are considered in the evaluation to include “de facto agents,” which continues to be a difficult concept to apply.

EITF 04-5 (Evolution of SOP 78-9 — Extinct, but Many of Its Concepts Survived as Part of Identifying Whether a Limited Partnership Is a VIE)

Before EITF 04-5, general partners of limited partnerships (and similar entities) analogized to the guidance in SOP 78-9 to determine whether the limited partner’s rights prevented the general partner from consolidating the partnership. Although EITF 04-5 resulted in amendments to the guidance on evaluating whether a general partner should consolidate a limited partnership, the evaluation still focused on the rights held by the limited partners. Specifically, under EITF 04-5, a general partner was presumed to control a limited partnership that was not a VIE. However, if the limited partners held substantive kick-out or participating rights, this presumption could have been overcome. Although EITF 04-5 (codified in ASC 810-20) was rescinded by ASU 2015-02, the concept survived, and a general partner is now required to evaluate the rights of the limited partners in the determination of whether the limited partnership (or similar entity) is a VIE. See the discussion of ASU 2015-02 below.

Statement 167 (Evolution of FIN 46(R))

The financial crisis in the late 2000s had a significant effect on the economy and, in turn, on the structures and financial statements of many companies. This, along with concerns related to the consolidation conclusions reached under the VIE model, resulted in the FASB’s reconsideration of the VIE model introduced by FIN 46(R). As mentioned above, FIN 46(R) completely separated the analysis of whether a reporting entity had power over a VIE from the analysis of whether the reporting entity should consolidate the VIE. Rather, the evaluation focused on the reporting entity’s economic exposure to the
VIE. Statement 167 represented a significant reversal from the view that a VIE should be consolidated by a reporting entity solely as a result of the reporting entity’s economic exposure to the VIE. Instead, although Statement 167 retained the concept of a VIE, it amended the guidance to require a reporting entity to consolidate a VIE if it has both (1) the power to direct the activities of the VIE that most significantly affect the VIE’s economic performance and (2) a variable interest in the VIE that is potentially significant.

Although Statement 167’s power requirement for consolidation of a VIE was a significant improvement over the FIN 46(R) guidance, many complexities remained in identifying VIEs and determining which party should consolidate them. In addition, because of a concern that the Statement 167 VIE model would result in unnecessary consolidation by investment managers of the funds they manage, the FASB provided a deferral specific to interests in investment companies (and certain other similar entities). Under the deferral, reporting entities with interests in a qualifying investment company continued to apply the FIN 46(R) model when evaluating whether the legal entity was a VIE and should be consolidated. Accordingly, when Statement 167 was adopted, reporting entities had to determine whether their interest was in a legal entity that was within the scope of the voting interest entity model, the FIN 46(R) VIE model, the Statement 167 VIE model, or the EITF 04-5 model.

**ASU 2015-02 (Further Evolution of the VIE Model and Extinction of EITF 04-5)**

ASU 2015-02 continued the consolidation evolution story. While the ASU did not introduce any new models, it revised the VIE model and eliminated EITF 04-5, requiring all legal entities to be evaluated as either a voting interest entity or VIE. Further, under the ASU, the evaluation of whether a VIE should be consolidated is still based on whether the reporting entity has both (1) power and (2) potentially significant economics.

Some key highlights of the ASU’s changes are as follows:

- The Statement 167 deferral for interests in investment companies (and certain similar entities) was eliminated, thereby removing from U.S. GAAP the risks-and-rewards-based consolidation model under FIN 46(R).
- The limited partnership model in ASC 810-20 was eliminated. As a result, limited partnerships are VIEs unless the limited partners have substantive kick-out or participating rights. Consequently, while more limited partnerships are VIEs, it is less likely that a general partner will consolidate a limited partnership.
- The guidance on fees paid to a decision maker or service provider was amended. Accordingly, the fees themselves are less likely to be considered a variable interest, a legal entity is less likely to be a VIE, and a decision maker is less likely to consolidate the legal entity.
- The ASU significantly amended how variable interests held by a reporting entity’s related parties or de facto agents affect its consolidation conclusion. In addition, the related-party tiebreaker test (and mandatory consolidation by one of the related parties) will be performed less frequently than under the previous VIE models.
ASU 2016-17 (Continued Evolution of the VIE Model)

Related-party considerations in the primary-beneficiary analysis (see Section 7.4) evolved under ASU 2016-17. The FASB issued ASU 2016-17 to amend its guidance on a decision maker's consideration of indirect interests held through related parties under common control in the evaluation of whether the decision maker has both the power and potentially significant economics in the primary-beneficiary assessment. Under the ASU, a decision maker considers these interests proportionately in a manner similar to its consideration of indirect interests held through related parties that are not under common control. Before ASU 2016-17, a decision maker considered the related party's interest in the VIE in its entirety (as if held by the decision maker) when evaluating whether the decision maker had a potentially significant variability interest.

Although the change as a result of ASU 2016-17 was minor, its effect on decision makers is significant. The related-party tiebreaker test is performed more frequently under the ASU because it is less likely that decision makers will meet the economics criterion\(^1\) (see Section 7.3) on their own when their economic exposure to a VIE through a related party under common control is considered proportionately.

However, since it did not change how related-party interests are considered in the evaluation of whether a fee arrangement is a variable interest, ASU 2016-17 introduced asymmetry into the VIE model. Thus, indirect interests held through related parties under common control are considered as direct interests in the variable interest analysis but as indirect interests on a proportionate basis in the primary-beneficiary assessment. However, the FASB ultimately issued ASU 2018-17 in October 2018, as discussed further below, which aligns the evaluation of indirect interests held by related parties.

ASU 2018-17 (Continued Evolution of Related-Party Provisions)

ASU 2018-17 eliminates the asymmetry resulting from ASU 2016-17 regarding consideration of a decision maker's related-party interests in the VIE model described above. The ASU requires a decision maker to evaluate indirect interests held by related parties under common control in a similar manner when assessing whether the fee arrangement is a variable interest and whether the decision maker is the primary beneficiary; that is, those interests will be considered on a proportionate basis rather than in their entirety (see Section 4.4.2.3.2).

In addition, ASU 2018-17 broadens ASU 2014-07's private-company scope exception to the VIE guidance for certain entities that are under common control and have leasing arrangements. Under ASU 2018-17, the exception applies to all legal entities under common control as long as the reporting entity, the common-control parent, and the legal entity being evaluated for consolidation are not public business entities and meet certain criteria (see Section 3.5).

The guidance in ASU 2018-17 is effective for public business entities in periods beginning after December 15, 2019, and for private entities in periods beginning after December 15, 2021. Early adoption is permitted.

\(^1\) Throughout this Roadmap, we refer to the characteristics described in ASC 810-10-25-38A(b) as the "economics criterion." See Section 7.1 for further discussion.
Continued Evolution?

The voting interest entity model and VIE model have survived evolution thus far. Are we entering another period in which only minor changes will be made to the consolidation requirements, such as the one enjoyed from 1959 to 2002? Or will economic conditions, transaction structures that continue to evolve in response to changing regulatory and tax environments, FASB priorities, or some combination thereof prompt further changes to address the future environment?

Over the years, many of the amendments to the models were designed to identify the appropriate consolidation framework for different types of legal entities. In the 1990s, the EITF made several attempts to define an SPE. And for the past 16 years, practitioners have been applying the complex guidance on identifying a VIE. A single model under which a controlling financial interest can be determined regardless of whether a legal entity is a VIE has yet to be achieved, but it would simplify the analysis (and this Roadmap).

In September 2017, the FASB issued a proposed ASU that would reorganize all the consolidation guidance and move it to a new topic (ASC 812), which would contain two separate subtopics: one for VIEs and one for voting interest entities. The Board issued the proposal in connection with its project to reorganize the consolidation guidance, which it undertook in response to feedback that ASC 810 is often "difficult to navigate." The Board's goal is to organize the guidance to reflect the order in which the consolidation analysis should occur.

Consolidation Decision Trees

ASC 810-10-05-6 contains a flowchart that consists of a series of decision trees to help reporting entities identify (1) which consolidation model to apply, if any; (2) whether a reporting entity should consolidate a VIE; and (3) whether a reporting entity should consolidate a voting interest entity. The flowchart below incorporates the concepts in the FASB's flowchart and serves as a guide to the consolidation accounting literature and this Roadmap.

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2 As of the date of the publication of this Roadmap, the FASB is continuing to consider this reorganization project. If it moves forward with the project, the Board also plans to develop nonauthoritative educational materials to support and supplement the reorganized authoritative consolidation guidance, particularly regarding aspects of the guidance that historically have been difficult to apply.

3 ASC 810-10-05-6 states that the flowchart "provides an overview of the guidance in this Subtopic for evaluating whether a reporting entity should consolidate another legal entity. The flowchart does not include all of the guidance in this Subtopic and is not intended as a substitute for the guidance in this Subtopic."
Consolidation is not required; however, other GAAP may be relevant to the determination of recognition, measurement, or disclosure.

* Interests in low-income housing tax partnerships within the scope of ASU 2014-01 would not be subject to this requirement.

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* Consolidation is not required; however, other GAAP may be relevant to the determination of recognition, measurement, or disclosure.

** Interests in low-income housing tax partnerships within the scope of ASU 2014-01 would not be subject to this requirement.
1.1 Which Consolidation Model to Apply

Under U.S. GAAP, there are two primary consolidation models: (1) the voting interest entity model and (2) the VIE model. Both accounting models require the reporting entity to identify whether it has a “controlling financial interest” in a legal entity and is therefore required to consolidate the legal entity. This requirement is not limited to legal entities that are VIEs — a reporting entity must consolidate any legal entity in which it has a controlling financial interest.

Under the voting interest entity model, a reporting entity with ownership of a majority of the voting interests of a legal entity is generally considered to have a controlling financial interest in the legal entity (see Section 1.3 for information about the voting interest entity model). However, the VIE model (see Section 1.2) was established for situations in which control may be demonstrated other than by the possession of voting rights in a legal entity. Accordingly, the evaluation of whether a reporting entity has a controlling financial interest in a VIE focuses on “the power to direct the activities of a VIE that most significantly impact the VIE’s economic performance” and “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.”

The flowchart segment on this page illustrates the relevant questions (a series of “scope” questions) for determining which consolidation model a reporting entity should apply. The analysis begins with the reporting entity’s evaluation of whether the legal entity is a VIE and therefore subject to the consolidation requirements under the VIE model. Only if a legal entity does not meet...
the definition of a VIE, or the reporting entity qualifies for a VIE scope exception, would the reporting entity apply the voting interest entity model or other applicable GAAP.

1.1.1 Is There a Legal Entity?

The scope of the consolidation guidance in ASC 810-10 is limited to a reporting entity’s involvement with another legal entity. The Codification defines “legal entity” broadly; therefore, almost any legal structure that is used to own assets, issue debt, or otherwise conduct activities would meet the definition of a legal entity. The particular legal form of the entity (e.g., a corporation, a partnership, a limited liability company, a grantor trust, or other trust) is not relevant to the determination of whether the structure is a legal entity. Divisions, departments, branches, and pools of assets are examples of components that are typically not separate legal entities. See Section 3.2.

If the reporting entity is involved with a legal entity, the reporting entity must continue its consolidation analysis.

1.1.2 Does a Scope Exception Apply?

A reporting entity may be exempt from analyzing a legal entity for consolidation as a result of a general scope exception (see Section 3.3) or from analyzing a legal entity for consolidation under only the VIE requirements if the legal entity qualifies for a VIE scope exception (see Section 3.4). The general scope exceptions are designed to prevent consolidation of a legal entity by a reporting entity that applies other guidance under U.S. GAAP on (1) employee benefit plans, (2) investment companies, (3) governmental entities, or (4) certain money market funds. If any of these exceptions are applicable, the reporting entity should not consolidate the legal entity under ASC 810. In addition, in developing the VIE model, the FASB determined that certain reporting entities should be exempt from analyzing whether a legal entity is a VIE.

If a scope exception does not apply, the reporting entity must continue its consolidation analysis. If a scope exception applies only to the VIE model, the voting interest entity model must be applied.

1.1.3 Does the Reporting Entity Hold a Variable Interest in the Legal Entity?

The VIE model created the concept of a “variable interest.” If a reporting entity does not hold a variable interest in a legal entity, it can stop its consolidation analysis. While there are many forms of variable interests, all variable interests will absorb portions of a VIE’s variability (changes in the fair value of the VIE’s net assets exclusive of variable interests) that the legal entity was designed to create. An interest that creates variability would not be considered a variable interest.

It is often easy to identify whether an arrangement is a variable interest. A good rule of thumb is that most arrangements that are on the credit side of the balance sheet (e.g., equity and debt) are variable interests because they absorb variability as a result of the performance of the legal entity, while items on the debit side of the balance sheet are typically not variable interests because they create variability for the legal entity. However, identifying whether other arrangements (e.g., derivatives, leases, and decision-maker and other service-provider contracts) are variable interests can be more complex. See Chapter 4 for further discussion of variable interests.

If a reporting entity holds a variable interest, the reporting entity must continue its consolidation analysis.
1.1.4 Is the Legal Entity a VIE?

Consolidation conclusions under the VIE model can be different from those under the voting interest entity model (and additional disclosures are required for VIEs). Therefore, it is important to determine which model to apply. The difference between a VIE and voting interest entity can be subtle, and the reporting entity needs to completely understand all contractual arrangements (explicit and implicit) as well as the design and purpose of the legal entity. In addition, the criteria for determining whether a limited partnership (or similar entity) is a VIE are different from the criteria for any other legal entity (see Chapter 5 for a complete description of these differences).

ASC 810 provides several characteristics to consider in determining whether an entity is a VIE. Only one of the following characteristics needs to be met (i.e., one characteristic cannot be overcome by consideration of the others) for a conclusion to be reached that the legal entity is a VIE:

- The legal entity does not have sufficient equity investment at risk.
- The equity investors at risk, as a group, lack the characteristics of a controlling financial interest.
- The entity is structured with disproportionate voting rights, and substantially all of the activities are conducted on behalf of an investor with disproportionately few voting rights.

1.2 The VIE Model

The VIE model requires a reporting entity to identify a controlling financial interest when voting interests may not appropriately indicate which party should consolidate a legal entity. Accordingly, if a determination is made that a legal entity is a VIE, the reporting entity will consolidate the VIE if the reporting entity has both (1) the power to direct the activities of the VIE that most significantly affect the VIE’s economic performance and (2) 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. In addition, even if it is apparent that an equity owner would be required to consolidate a legal entity under the voting interest entity model, it must still evaluate whether the legal entity is a VIE and whether it would be required to consolidate the legal entity under the VIE requirements, because there are different measurement requirements for VIEs and additional presentation and disclosure requirements under the VIE model if certain criteria are met. While determining whether the power and economics criteria have been satisfied might appear straightforward, it is often difficult in practice. The reporting entity must exercise significant judgment in making its determination.
Further, as discussed in detail in Chapter 7, the consolidation analysis will vary when, among other factors, (1) there is a single decision maker, (2) power is shared between related parties as opposed to unrelated parties, (3) different parties direct the same significant activity, (4) different parties direct different significant activities, (5) related parties are under common control, and (6) substantially all the activities involve or are conducted on behalf of a single related party.

1.3 The Voting Interest Entity Model

Under the voting interest entity model, a reporting entity consolidates a legal entity when it has a controlling financial interest in the legal entity through its ownership of voting interests. The voting interest entity model is codified entirely in ASC 810-10. Accordingly, limited partnerships (and similar entities) that are not VIEs are evaluated for consolidation in the same manner as corporations that are not VIEs.

1.3.1 Limited Partnerships (and Similar Entities)

For limited partnerships (and similar entities) that are not VIEs, the identification of a controlling financial interest focuses on (1) whether any limited partner owns substantive kick-out rights that give it the unilateral right to remove the general partner or dissolve the partnership without cause and (2) whether the noncontrolling limited partners do not have substantive participating rights. Under ASC 810-10, a general partner will not consolidate a limited partnership under the voting interest entity model. Rather, only a limited partner that has the unilateral right to remove the general partner or dissolve the partnership would do so.

1.3.2 Legal Entities That Are Not Limited Partnerships (or Similar Entities)

For legal entities that are not limited partnerships (and not VIEs), the identification of a controlling financial interest focuses on whether the reporting entity has voting interests that give it control over the financial and operating policies of the legal entity. A controlling financial interest typically exists when a reporting entity owns more than 50 percent of the outstanding voting shares of another entity and the noncontrolling shareholders do not have substantive participating rights. However, there are exceptions to this general principle, including when control exists without a majority voting interest and control does not exist with a majority voting interest.

See Appendix D for a discussion of the voting interest entity model.
1.3.3 Control by Contract

In addition to the VIE and voting interest entity models, ASC 810-10 contains guidance on evaluating entities that are controlled by contract and are not deemed to be VIEs. With the introduction of the VIE model, the relevance of the contract-controlled entity model has diminished. This is because a legal entity that is controlled by contract would most likely be a VIE since one of the conditions to qualify as a voting interest entity is that the equity investors at risk must control the most significant activities of the legal entity. Under the proposed ASU issued by the FASB in September 2017 as part of its consolidation reorganization project, this guidance could be moved or amended.

See Section D.3.4 for further discussion of the contract-controlled entity model.

1.4 Key Differences Between the Voting Interest Entity Model and the VIE Model

The following table compares key concepts under the voting interest entity model and the VIE model:

<table>
<thead>
<tr>
<th>Concept</th>
<th>Voting Interest Entity Model</th>
<th>VIE Model</th>
</tr>
</thead>
</table>
| Definition of a controlling financial interest | For legal entities other than limited partnerships, the usual condition for consolidation is ownership of a majority voting interest.  
For limited partnerships (and similar entities), the usual condition for consolidation is ownership of a majority of the limited partnership's kick-out rights.  
However, for all legal entities, control may not rest with the majority owner if certain conditions exist. | A reporting entity has a controlling financial interest if it has both of the following characteristics: (1) the power to direct the activities of the entity that most significantly affect the entity's economic performance and (2) the obligation to absorb losses of the entity that could potentially be significant to the entity or the right to receive benefits from the entity that could potentially be significant to the entity.  
Under the VIE model (unlike the voting interest entity model), a broader list of activities is typically considered in the determination of which party, if any, should consolidate. |
<p>| Impact of related parties      | Related parties and de facto agents are not considered.                                         | Related parties, including de facto agents, must be considered. The identification of related parties can have a significant impact on the consolidation analysis, including potentially requiring one of the related parties to consolidate even though the reporting entity, on its own, does not have a controlling financial interest. See Section 8.3 for a discussion of how related parties affect the analysis under the VIE model. |</p>
<table>
<thead>
<tr>
<th>Concept</th>
<th>Voting Interest Entity Model</th>
<th>VIE Model</th>
</tr>
</thead>
<tbody>
<tr>
<td>Participating rights —</td>
<td>Participating rights allow the limited partners or noncontrolling shareholders to block or participate in certain significant financial and operating decisions of the limited partnership or the corporation that are made in the ordinary course of business.</td>
<td>Participating rights provide the ability to block or participate in the actions through which an entity exercises the power to direct the activities of a VIE that most significantly affect the VIE’s economic performance. To have a substantive participating right in determining whether a limited partnership or similar entity is a VIE, the limited partners must participate in certain significant financial and operating decisions that occur as part of the ordinary course of the limited partnership’s business in a manner similar to their participation under the voting interest entity model. However, to be a substantive participating right and preclude another party from controlling, the right must be held by a single reporting entity and unilaterally exercisable relative to the activities that most significantly affect the economic performance of the VIE.</td>
</tr>
<tr>
<td>definition</td>
<td>An owner of a majority voting interest will be precluded from consolidating if a noncontrolling shareholder or limited partner has a substantive participating right in certain (but not all) significant financial and operating decisions that occur as part of the ordinary course of the investee’s business.</td>
<td></td>
</tr>
<tr>
<td></td>
<td>In addition, the voting interest definition is used for limited partnerships (and similar entities) in the determination of whether the partnership is a VIE.</td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Forward starting rights and</td>
<td>Only existing voting rights are considered in the analysis of which party has a controlling financial interest.</td>
<td>Since the evaluation of economic performance, and therefore determining which reporting entity has power over the activities that most significantly affect the VIE’s economic performance, takes into account the life of the legal entity, forward starting rights are considered in the primary-beneficiary determination. In addition, forward starting rights as a result of a contingent event should be evaluated in the determination of whether the contingency initiates or results in a change in power and, for the latter, whether the contingency is substantive. See Section 7.2.9.</td>
</tr>
<tr>
<td>potential voting rights</td>
<td>Potential voting rights are not considered until they are currently held unless they are deemed to be held because of a nonsubstantive exercise or purchase price and there are no significant decisions in the ordinary course of business that will be made before the potential voting right is exercisable. See Section D.1.4.</td>
<td></td>
</tr>
<tr>
<td>Disclosures</td>
<td>The required disclosures for consolidated subsidiaries are limited, including disclosures related to consolidated subsidiaries that are not wholly owned.</td>
<td>In addition to the general disclosures required for consolidated voting interest entities, there are specific VIE disclosures for consolidated and unconsolidated VIEs. See Section 11.2.</td>
</tr>
</tbody>
</table>
In constructing the concept of a VIE, the FASB invented a new language of sorts. At times, its nomenclature has proven difficult to understand because many of the terms are esoteric and do not appear in other areas of GAAP. The purpose of this chapter is to briefly explain some of the key terminology introduced by the consolidation models and to indicate where the related concepts are more fully discussed in this Roadmap.

### 2.1 Controlling Financial Interest

<table>
<thead>
<tr>
<th>ASC 810-10</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Objectives — General</strong></td>
</tr>
<tr>
<td><strong>10-1</strong> The purpose of consolidated financial statements is to present, primarily for the benefit of the owners and creditors of the parent, the results of operations and the financial position of a parent and all its subsidiaries as if the consolidated group were a single economic entity. There is a presumption that consolidated financial statements are more meaningful than separate financial statements and that they are usually necessary for a fair presentation when one of the entities in the consolidated group directly or indirectly has a controlling financial interest in the other entities.</td>
</tr>
</tbody>
</table>

A reporting entity that consolidates another legal entity holds a “controlling financial interest” in that legal entity. Such legal entities are not limited to VIEs — the party that consolidates any legal entity is said to have a controlling financial interest in that legal entity.

Under the voting interest entity model, a reporting entity with ownership of a majority of the voting interests is generally considered to have a controlling financial interest (see Appendix D for information about the voting interest entity model). However, as discussed in Chapter 1, the VIE model was established for situations in which control may be demonstrated other than by the possession of voting rights in a legal entity. Accordingly, the evaluation of whether a reporting entity has a controlling financial interest in a VIE focuses on “the power to direct the activities of a VIE that most significantly impact the VIE’s economic performance” and “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.”

The reporting entity that has a controlling financial interest in a VIE is sometimes the same party that holds a majority of the voting interests. See Chapter 7 for guidance on how a reporting entity should assess whether it has a controlling financial interest in a VIE.
2.2 Decision Maker

**Decision Maker**

An entity or entities with the power to direct the activities of another legal entity that most significantly impact the legal entity's economic performance according to the provisions of the Variable Interest Entities Subsections of Subtopic 810-10.

A legal entity may have multiple decision makers, examples of which include equity owners, asset managers, servicers of asset backed securitizations, real estate property managers, hotel operators, oil and gas plant operators, and utility plant operators.

Until the FASB issued ASU 2015-02, the concept of a “decision maker” was never formally defined. Many of ASU 2015-02’s amendments to ASC 810-10 focus on the evaluation of whether a reporting entity has the first characteristic of a controlling financial interest in a VIE (i.e., the power to direct the activities that most significantly affect the VIE’s economic performance). Paragraph BC76 of ASU 2015-02 states that if the criteria in ASC 810-10-55-37 are met, the decision maker is deemed to be acting as a fiduciary on behalf of the legal entity and its variable interest holders. Such a decision maker would therefore not be subject to consolidation under the VIE model (and therefore would not have power because of its fiduciary role). Conversely, if a decision maker does not meet all of the criteria in ASC 810-10-55-37, the decision maker is subject to further evaluation under the VIE model. See Section 4.4 for a detailed discussion of whether fees paid to an entity’s decision maker are considered a variable interest.

2.3 Expected Losses, Expected Residual Returns, and Expected Variability

**Expected Losses**

A legal entity that has no history of net losses and expects to continue to be profitable in the foreseeable future can be a variable interest entity (VIE). A legal entity that expects to be profitable will have expected losses. A VIE’s expected losses are the expected negative variability in the fair value of its net assets exclusive of variable interests and not the anticipated amount or variability of the net income or loss.

**Expected Residual Returns**

A variable interest entity’s (VIE’s) expected residual returns are the expected positive variability in the fair value of its net assets exclusive of variable interests.

**Expected Losses and Expected Residual Returns**

Expected losses and expected residual returns refer to amounts derived from expected cash flows as described in FASB Concepts Statement No. 7, *Using Cash Flow Information and Present Value in Accounting Measurements*. However, expected losses and expected residual returns refer to amounts discounted and otherwise adjusted for market factors and assumptions rather than to undiscounted cash flow estimates. The definitions of expected losses and expected residual returns specify which amounts are to be considered in determining expected losses and expected residual returns of a variable interest entity (VIE).

**Expected Variability**

Expected variability is the sum of the absolute values of the expected residual return and the expected loss. Expected variability in the fair value of net assets includes expected variability resulting from the operating results of the legal entity.
While the terms “expected losses,” “expected residual returns,” and “expected variability” can be difficult to understand, the concepts underlying them are critical to comprehending many of the VIE model’s other terms and concepts. See Appendix C for a detailed discussion of these terms as well as a history of the purpose of the quantitative calculations inherent in them.

2.4 Kick-Out Rights

<table>
<thead>
<tr>
<th>ASC 810-10 — Glossary</th>
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</thead>
<tbody>
<tr>
<td><strong>Kick-Out Rights (VIE Definition)</strong></td>
</tr>
<tr>
<td>The ability to remove the entity with the power to direct the activities of a VIE that most significantly impact the VIE’s economic performance or to dissolve (liquidate) the VIE without cause.</td>
</tr>
<tr>
<td><strong>Kick-Out Rights (Voting Interest Entity Definition)</strong></td>
</tr>
<tr>
<td>The rights underlying the limited partner’s or partners’ ability to dissolve (liquidate) the limited partnership or otherwise remove the general partners without cause.</td>
</tr>
</tbody>
</table>

In the determination of whether a legal entity is a VIE, two different definitions of kick-out rights apply depending on whether the legal entity is (1) a limited partnership (or similar entity) that uses the voting interest entity definition or (2) other than a limited partnership (or similar entity) that uses the VIE definition. Both definitions have a similar theme (i.e., whether the party that is making decisions about a legal entity can be removed without cause). In the evaluation of whether a legal entity is a VIE, a decision maker does not have control over a legal entity if another party or parties have the substantive right to remove the decision maker without cause.

In the analysis of a legal entity other than a limited partnership, the VIE definition should be applied. For these types of legal entities, a kick-out right is substantive if a single equity holder at risk (including its related parties and de facto agents) is able to exercise the kick-out right (see Section 5.3.1.1.3.4). If the single equity holder has a substantive kick-out right, the equity investors at risk, as a group, would possess the power to direct the most significant activities of the legal entity.

The definition of kick-out rights in the evaluation of whether a limited partnership (or similar entity) is a VIE is the same as the definition that applies under the voting interest entity model. For a kick-out right to be substantive for a limited partnership (or similar entity), a simple majority (or lower threshold) of the limited partner interests (excluding those held by the general partner, entities under common control with the general partner, and entities acting on behalf of the general partner) must be able to remove the general partner without cause (see Section 5.3.1.2.2).

For kick-out rights to affect the consolidation analysis under either definition, the rights must be substantive (i.e., there can be no significant barriers to exercising those rights). See Section 5.3.1.2.4 for guidance on determining whether kick-out rights are substantive.
2.5 Legal Entity

**ASC 810-10 — Glossary**

**Legal Entity**
Any legal structure used to conduct activities or to hold assets. Some examples of such structures are corporations, partnerships, limited liability companies, grantor trusts, and other trusts.

Throughout this Roadmap, we refer to the entity that is analyzed for potential consolidation as the “legal entity.” Both the VIE model and the voting interest entity model require a reporting entity to evaluate its involvement with any legal entity to establish whether consolidation of the legal entity is required. The assessment of whether a structure is a legal entity is a critical first step in the overall consolidation analysis. A common misconception is that a legal entity has to be incorporated or registered with some type of governmental agency or regulatory body. The definition of a legal entity is meant to be extensive and depends on specific facts and circumstances. See Section 3.2 for more details.

2.6 Participating Rights

**ASC 810-10 — Glossary**

**Participating Rights (VIE Definition)**
The ability to block or participate in the actions through which an entity exercises the power to direct the activities of a VIE that most significantly impact the VIE’s economic performance. Participating rights do not require the holders of such rights to have the ability to initiate actions.

**Participating Rights (Voting Interest Entity Definition)**
Participating rights allow the limited partners or noncontrolling shareholders to block or participate in certain significant financial and operating decisions of the limited partnership or corporation that are made in the ordinary course of business. Participating rights do not require the holders of such rights to have the ability to initiate actions.

Participating rights give a party or a group of parties the ability to either participate in or block the actions that are most significant to a legal entity’s economic performance. Decision makers do not have a controlling financial interest if another party has the **substantive** right to participate in their decisions. Holders of participating rights are not required to have the ability to initiate actions for their rights to be substantive. Like kick-out rights, participating rights must be substantive to be considered in the VIE analysis.

As described in Sections 5.3.1.1.3.5 and 5.3.1.2.7, in determining whether a legal entity is a VIE, a reporting entity analyzes the impact of the existence of substantive participating rights differently depending on whether the legal entity is a limited partnership (or similar entity). That is, the evaluation of participating rights under the voting interest entity model focuses on whether the holder of such rights can participate in certain significant financial and operating decisions of the entity, while the evaluation of such rights under the VIE model focuses on whether the holder can participate in the most significant activities of the entity. The evaluation of whether a limited partnership is a VIE is based on the voting interest entity definition of a participating right. Accordingly, it is important to determine which activities the limited partners can participate in.
2.7 Protective Rights

**ASC 810-10 — Glossary**

**Protective Rights (VIE Definition)**
Rights designed to protect the interests of the party holding those rights without giving that party a controlling financial interest in the entity to which they relate. For example, they include any of the following:

a. Approval or veto rights granted to other parties that do not affect the activities that most significantly impact the entity's economic performance. Protective rights often apply to fundamental changes in the activities of an entity or apply only in exceptional circumstances. Examples include both of the following:
   1. A lender might have rights that protect the lender from the risk that the entity will change its activities to the detriment of the lender, such as selling important assets or undertaking activities that change the credit risk of the entity.
   2. Other interests might have the right to approve a capital expenditure greater than a particular amount or the right to approve the issuance of equity or debt instruments.

b. The ability to remove the reporting entity that has a controlling financial interest in the entity in circumstances such as bankruptcy or on breach of contract by that reporting entity.

c. Limitations on the operating activities of an entity. For example, a franchise agreement for which the entity is the franchisee might restrict certain activities of the entity but may not give the franchisor a controlling financial interest in the franchisee. Such rights may only protect the brand of the franchisor.

**Protective Rights (Voting Interest Entity Definition)**
Rights that are only protective in nature and that do not allow the limited partners or noncontrolling shareholders to participate in significant financial and operating decisions of the limited partnership or corporation that are made in the ordinary course of business.

While protective rights protect the interests of the holder, they do not allow the holder to participate in the significant financial and operating decisions made in a voting interest entity's ordinary course of business or to participate in the significant activities of a VIE. Unlike participating rights, protective rights do not preclude another entity from having the power to direct the most significant activities of a legal entity.

Both protective rights and participating rights are approval or veto rights. The key to differentiating between the two types of rights is the underlying activity or action to which the rights relate. Protective rights often apply to fundamental changes in the activities of a legal entity or apply only in extraordinary circumstances. Participating rights involve the ability to approve or veto the significant financial and operating decisions for a voting interest entity and the activities that most significantly affect a legal entity's economic performance for a VIE, and would generally be expected to occur in an entity's normal course of business.

ASC 810-10-25-10 lists protective rights (not all-inclusive) that are often provided to the noncontrolling shareholder or limited partner of a voting interest entity. The rights pertain to the following:

a. Amendments to articles of incorporation or partnership agreements of the investee
b. Pricing on transactions between the owner of a majority voting interest or limited partner with a majority of kick-out rights through voting interests and the investee and related self-dealing transactions
c. Liquidation of the investee in the context of Topic 852 on reorganizations or a decision to cause the investee to enter bankruptcy or other receivership
d. Acquisitions and dispositions of assets that are not expected to be undertaken in the ordinary course of business (noncontrolling rights relating to acquisitions and dispositions of assets that are expected to be made in the ordinary course of business are participating rights; determining whether such rights are substantive requires judgment in light of the relevant facts and circumstances [see paragraphs 810-10-25-13 and 810-10-55-1])
e. Issuance or repurchase of equity interests.
Determining whether rights are protective or participating may require significant judgment. Depending on the facts and circumstances, rights that are protective in one instance may be participating in another.

2.8 Primary Beneficiary

<table>
<thead>
<tr>
<th>ASC 810-10 — Glossary</th>
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</thead>
<tbody>
<tr>
<td><strong>Primary Beneficiary</strong></td>
</tr>
<tr>
<td>An entity that consolidates a variable interest entity (VIE). See paragraphs 810-10-25-38 through 25-38j for guidance on determining the primary beneficiary.</td>
</tr>
</tbody>
</table>

A reporting entity that consolidates (i.e., has a controlling financial interest in) a VIE is the “primary beneficiary” of the VIE. See Chapter 7 for a detailed discussion of how a reporting entity should assess whether it has a controlling financial interest and is therefore the primary beneficiary of the VIE.

2.9 Private Company

<table>
<thead>
<tr>
<th>ASC 810-10 — Glossary</th>
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</thead>
<tbody>
<tr>
<td><strong>Private Company</strong></td>
</tr>
<tr>
<td>An entity other than a public business entity, a not-for-profit entity, or an employee benefit plan within the scope of Topics 960 through 965 on plan accounting.</td>
</tr>
</tbody>
</table>

A reporting entity that meets the definition of a private company can elect to apply ASU 2014-07, which provides an accounting alternative to the VIE model for private lessor entities under common control. In October 2018, the FASB issued ASU 2018-17, which broadens the existing accounting alternative that is available to private companies by allowing all legal entities under common control to elect not to apply the VIE guidance as long as certain criteria are met. See Section 3.5 for details.

2.10 Public Business Entity

<table>
<thead>
<tr>
<th>ASC 810-10 — Glossary</th>
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</thead>
<tbody>
<tr>
<td><strong>Public Business Entity</strong></td>
</tr>
<tr>
<td>A public business entity is a business entity meeting any one of the criteria below. Neither a not-for-profit entity nor an employee benefit plan is a business entity.</td>
</tr>
<tr>
<td>a. It is required by the U.S. Securities and Exchange Commission (SEC) to file or furnish financial statements, or does file or furnish financial statements (including voluntary filers), with the SEC (including other entities whose financial statements or financial information are required to be or are included in a filing).</td>
</tr>
<tr>
<td>b. It is required by the Securities Exchange Act of 1934 (the Act), as amended, or rules or regulations promulgated under the Act, to file or furnish financial statements with a regulatory agency other than the SEC.</td>
</tr>
<tr>
<td>c. It is required to file or furnish financial statements with a foreign or domestic regulatory agency in preparation for the sale of or for purposes of issuing securities that are not subject to contractual restrictions on transfer.</td>
</tr>
<tr>
<td>d. It has issued, or is a conduit bond obligor for, securities that are traded, listed, or quoted on an exchange or an over-the-counter market.</td>
</tr>
<tr>
<td>e. It has one or more securities that are not subject to contractual restrictions on transfer, and it is required by law, contract, or regulation to prepare U.S. GAAP financial statements (including notes) and make them publicly available on a periodic basis (for example, interim or annual periods). An entity must meet both of these conditions to meet this criterion.</td>
</tr>
</tbody>
</table>
ASC 810-10 — Glossary (continued)

An entity may meet the definition of a public business entity solely because its financial statements or financial information is included in another entity's filing with the SEC. In that case, the entity is only a public business entity for purposes of financial statements that are filed or furnished with the SEC.

The effective date of ASU 2018-17 (see Section 3.5), and whether a reporting entity can elect to apply ASU 2014-07 and ASU 2018-17 for a “private company” as defined in Section 2.9, depends on whether the reporting entity is a public business entity.

2.11 Related Parties, De Facto Agents, and Common Control

ASC 810-10 — Glossary

Related Parties

Related parties include:

a. Affiliates of the entity
b. Entities for which investments in their equity securities would be required, absent the election of the fair value option under the Fair Value Option Subsection of Section 825-10-15, to be accounted for by the equity method by the investing entity
c. Trusts for the benefit of employees, such as pension and profit-sharing trusts that are managed by or under the trusteeship of management
d. Principal owners of the entity and members of their immediate families
e. Management of the entity and members of their immediate families
f. Other parties with which the entity may deal if one party controls or can significantly influence the management or operating policies of the other to an extent that one of the transacting parties might be prevented from fully pursuing its own separate interests
g. Other parties that can significantly influence the management or operating policies of the transacting parties or that have an ownership interest in one of the transacting parties and can significantly influence the other to an extent that one or more of the transacting parties might be prevented from fully pursuing its own separate interests.

2.11.1 De Facto Agents

ASC 810-10

25-43 For purposes of applying the guidance in the Variable Interest Entities Subsections, unless otherwise specified, the term related parties includes those parties identified in Topic 850 and certain other parties that are acting as de facto agents or de facto principals of the variable interest holder. All of the following are considered to be de facto agents of a reporting entity:

a. A party that cannot finance its operations without subordinated financial support from the reporting entity, for example, another VIE of which the reporting entity is the primary beneficiary
b. A party that received its interests as a contribution or a loan from the reporting entity
c. An officer, employee, or member of the governing board of the reporting entity
d. A party that has an agreement that it cannot sell, transfer, or encumber its interests in the VIE without the prior approval of the reporting entity. The right of prior approval creates a de facto agency relationship only if that right could constrain the other party's ability to manage the economic risks or realize the economic rewards from its interests in a VIE through the sale, transfer, or encumbrance of those interests. However, a de facto agency relationship does not exist if both the reporting entity and the party have right of prior approval and the rights are based on mutually agreed terms by willing, independent parties. . . .
e. A party that has a close business relationship like the relationship between a professional service provider and one of its significant clients.
In initially introducing the VIE model, the FASB identified various structures in the marketplace that involved a reporting entity’s transaction with another party that would not have been identified as a related party under the traditional GAAP definition. In some instances, the FASB believed that the nature of the structure or the relationship with these other parties was significant enough to warrant additional scrutiny in a consolidation analysis. Consequently, for certain aspects of the VIE model, the FASB requires a reporting entity to identify related parties and de facto agents to prevent the reporting entity from avoiding consolidation of a VIE by protecting its interests or indirectly expanding its holdings through other entities that are effectively acting on its behalf. The identification of related parties and de facto agents is critical because those relationships have the potential to affect the consolidation analysis in multiple ways. For example, they can affect:

- Whether the potential VIE qualifies for the business scope exception.
- Whether an entity’s decision-maker or service-provider arrangement is a variable interest.
- Whether the potential VIE is, in fact, a VIE.
- The determination of the primary beneficiary of a VIE.

See Chapter 8 for more details.

2.11.2 Common Control

A reporting entity’s determination of whether related parties are under common control may be critical to its consolidation conclusion because the effects of interests held by such parties depend on this determination. While the Codification does not define common control, paragraph BC69 of ASU 2015-02 states that entities under common control include “subsidiaries controlled (directly or indirectly) by a common parent, or a subsidiary and its parent.” In this context, a parent includes any party that has a controlling financial interest in a subsidiary, and that party does not need to be a separate legal entity.

Oftentimes, entities will exhibit a high degree of common ownership. However, such ownership is not the same as common control, and a reporting entity therefore should not apply those terms synonymously in its consolidation analysis.

See Section 8.2.2 for further discussion.

2.12 Reporting Entity

Although not specifically defined in ASC 810-10-20, a “reporting entity” as used in ASC 810 (and therefore as used in this Roadmap) is the entity performing the consolidation analysis (i.e., the party potentially consolidating a legal entity).

2.13 Subordinated Financial Support

Subordinated financial support refers to a variable interest that absorbs a portion of a legal entity’s expected losses. If the terms of the arrangement cause the variable interest to absorb expected losses before or at the same level as the most subordinated interests (e.g., equity, subordinated debt), or the most subordinated interests are not large enough to absorb the entity’s expected losses, the variable interest would generally be considered subordinated financial support. Examples may include
non-investment-grade debt, contracts with terms that are not normal or customary, guarantees, derivatives, or a commitment to fund losses. The determination of whether a variable interest is subordinated financial support will be based on how that interest absorbs expected losses compared with other variable interests in a legal entity.

Understanding which variable interests constitute subordinated financial support can help a reporting entity determine the following in its evaluation under the VIE model:

- Which party has provided a potential VIE’s subordinated financial support in the evaluation of whether the potential VIE qualifies for the business scope exception (see Section 3.4.4.9).
- Whether a de facto agency relationship exists (see Section 8.2.3.1).
- Whether the potential VIE’s total equity investment at risk is sufficient to permit the legal entity to finance its activities without additional subordinated financial support (see Section 5.2.3).

### 2.14 Variable Interests

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<thead>
<tr>
<th>ASC 810-10 — Glossary</th>
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<tbody>
<tr>
<td><strong>Variable Interests</strong></td>
</tr>
<tr>
<td>The investments or other interests that will absorb portions of a variable interest entity’s (VIE’s) expected losses or receive portions of the entity’s expected residual returns are called variable interests. Variable interests in a VIE are contractual, ownership, or other pecuniary interests in a VIE that change with changes in the fair value of the VIE’s net assets exclusive of variable interests. Equity interests with or without voting rights are considered variable interests if the legal entity is a VIE and to the extent that the investment is at risk as described in paragraph 810-10-15-14. Paragraph 810-10-25-55 explains how to determine whether a variable interest in specified assets of a legal entity is a variable interest in the entity. Paragraphs 810-10-55-16 through 55-41 describe various types of variable interests and explain in general how they may affect the determination of the primary beneficiary of a VIE.</td>
</tr>
</tbody>
</table>

A reporting entity cannot consolidate a legal entity if it does not hold a variable interest in that legal entity. Variable interests exist in many different forms and will absorb portions of the variability that the VIE was designed to create. An interest that creates an entity’s variability is not a variable interest.

As a rule of thumb, most arrangements on the credit side of the balance sheet (e.g., equity and debt) are variable interests because they absorb variability as a result of the performance of the entity. However, identifying whether other arrangements, such as those involving derivatives, leases, or decision-maker and other service-provider contracts, are variable interests can be more complex. See Chapter 4 for additional details.

### 2.15 Variable Interest Entity

<table>
<thead>
<tr>
<th>ASC 810-10 — Glossary</th>
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<tbody>
<tr>
<td><strong>Variable Interest Entity</strong></td>
</tr>
<tr>
<td>A legal entity subject to consolidation according to the provisions of the Variable Interest Entities Subsections of Subtopic 810-10.</td>
</tr>
</tbody>
</table>
A VIE is a legal entity that is outside the scope of the traditional voting interest entity model. Specifically, a VIE does not qualify for any of the scope exceptions under ASC 810-10-15-12 or ASC 810-10-15-17 and meets one of the following three conditions:

1. The equity investment at risk is not sufficient for the legal entity to finance its activities without additional subordinated financial support. Said differently, the equity investors do not have sufficient “skin in the game.”

2. The holders of the equity investment at risk, as a group, lack the characteristics of a controlling financial interest. Equity investors do not have the attributes typically expected of an equity holder.

3. The voting rights of some holders of the equity investment at risk are disproportionate to their obligation to absorb losses or right to receive returns, and substantially all of the activities are conducted on behalf of the holder of equity investment at risk with disproportionately few voting rights. This is an anti-abuse provision designed to prevent structuring opportunities to circumvent consolidation under the voting interest entity model.

See Chapter 3 for guidance on scope exceptions, and see Chapter 5 for guidance on determining whether a legal entity meets the above three conditions.

2.16 Voting Interest Entity
The Codification does not define “voting interest entity,” but in practice the term has developed to mean any entity that is not a VIE as defined above in Section 2.15. Throughout this Roadmap, we refer to the analysis of a voting interest entity as the voting interest entity model. For guidance on applying the voting interest entity model, see Appendix D.

2.17 Collateralized Financing Entity

<table>
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<th>ASC 810-10 — Glossary</th>
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<tbody>
<tr>
<td><strong>Collateralized Financing Entity</strong></td>
</tr>
<tr>
<td>A variable interest entity that holds financial assets, issues beneficial interests in those financial assets, and has no more than nominal equity. The beneficial interests have contractual recourse only to the related assets of the collateralized financing entity and are classified as financial liabilities. A collateralized financing entity may hold nonfinancial assets temporarily as a result of default by the debtor on the underlying debt instruments held as assets by the collateralized financing entity or in an effort to restructure the debt instruments held as assets by the collateralized financing entity. A collateralized financing entity also may hold other financial assets and financial liabilities that are incidental to the operations of the collateralized financing entity and have carrying values that approximate fair value (for example, cash, broker receivables, or broker payables).</td>
</tr>
</tbody>
</table>

A collateralized financing entity (CFE) is an asset-backed financing or securitization entity typically with no substantive business purpose other than to issue beneficial interests in the financial assets it holds. Most securitization entities and other asset-backed financing vehicles, such as collateralized loan obligation entities (CLOs) and collateralized debt obligation entities (CDOs) are CFES. These entities are typically VIEs because their capital structure qualitatively demonstrates that there is insufficient equity investment at risk. See Sections E.1 and E.2 for consolidation considerations related to securitization structures and collateralized investment vehicles (CIVs), respectively. CLOs and CDOs are examples of entities that are referred to in this Roadmap as CIVs. Some reporting entities that consolidate a CFE elect to carry all of the financial assets and financial liabilities at fair value. Note that the FASB has provided a measurement alternative for consolidated CFES (see Sections 10.1.3 and 10.2.2).
Chapter 3 — Scope

Is the entity being evaluated for consolidation a legal entity? (Section 3.2)
- No: Stop consolidation analysis.
- Yes:
  - Does a scope exception to the consolidation guidance apply? (Section 3.3)
    - Yes: Stop consolidation analysis.
    - No:
      - Does a VIE subsection scope exception apply? (Section 3.4)
        - Yes: Evaluate under voting interest entity model.
        - No:
          - Does the reporting entity have a variable interest in the legal entity? (Chapter 4)
            - No:
              - Is the legal entity a VIE? (Chapter 5)
                - No:
                  - Perform related-party tiebreaker test (Section 7.4.2.4).
                - Yes:
                  - The party most closely associated with the VIE consolidates the VIE.
            - Yes:
              - Is there a single decision maker that is under common control with other parties in a group that collectively has potentially significant economic exposure? (Section 7.4.2.3)
                - Yes:
                  - For legal entities other than limited partnerships, does the reporting entity own a majority voting interest? OR For limited partnerships (and similar entities), does the reporting entity own a majority of the limited partnership’s kick-out rights through voting interests? (Section D.1)
                    - Yes:
                      - Stop consolidation analysis.
                    - No:
                      - For legal entities other than limited partnerships, does the reporting entity own a majority voting interest? OR For limited partnerships (and similar entities), does the reporting entity own a majority of the limited partnership’s kick-out rights through voting interests? (Section D.1)
                        - Yes:
                          - Stop consolidation analysis.
                        - No:
                          - Is power shared and does the related-party group have potentially significant economic exposure? (Section 7.4.2.2)
                            - Yes:
                              - Perform related-party tiebreaker test (Section 7.4.2.4).
                            - No:
                              - The party most closely associated with the VIE consolidates the VIE.
                        - No:
                          - Is there a single decision maker? Yes: Evaluate under voting interest entity model. No:
                            - Is there a single decision maker that is under common control with other parties in a group that collectively has potentially significant economic exposure? (Section 7.4.2.3)
                              - Yes:
                                - For legal entities other than limited partnerships, does the reporting entity own a majority voting interest? OR For limited partnerships (and similar entities), does the reporting entity own a majority of the limited partnership’s kick-out rights through voting interests? (Section D.1)
                                  - Yes:
                                    - Stop consolidation analysis.
                                  - No:
                                    - For legal entities other than limited partnerships, does the reporting entity own a majority voting interest? OR For limited partnerships (and similar entities), does the reporting entity own a majority of the limited partnership’s kick-out rights through voting interests? (Section D.1)
                                      - Yes:
                                        - Stop consolidation analysis.
                                      - No:
                                        - Is power shared and does the related-party group have potentially significant economic exposure? (Section 7.4.2.2)
                                          - Yes:
                                            - Perform related-party tiebreaker test (Section 7.4.2.4).
                                          - No:
                                            - The party most closely associated with the VIE consolidates the VIE.
    - No: Stop consolidation analysis.

* Consolidation is not required; however, other GAAP may be relevant to the determination of recognition, measurement, or disclosure.
### 3.1 Introduction

All reporting entities shall apply the guidance in the Consolidation Topic to determine whether and how to consolidate another entity and apply the applicable Subsection as follows:

a. If the reporting entity has an interest in an entity, it must determine whether that entity is within the scope of the Variable Interest Entities Subsections in accordance with paragraph 810-10-15-14. If that entity is within the scope of the Variable Interest Entities Subsections, the reporting entity should first apply the guidance in those Subsections. Paragraph 810-10-15-17 provides specific exceptions to applying the guidance in the Variable Interest Entities Subsections.

b. If the reporting entity has an interest in an entity that is not within the scope of the Variable Interest Entities Subsections and is not within the scope of the Subsections mentioned in paragraph 810-10-15-3(c), the reporting entity should use only the guidance in the General Subsections to determine whether that interest constitutes a controlling financial interest.

c. If the reporting entity has a contractual management relationship with another entity that is not within the scope of the Variable Interest Entities Subsections, the reporting entity should use the guidance in the Consolidation of Entities Controlled by Contract Subsections to determine whether the arrangement constitutes a controlling financial interest.

All legal entities are subject to this Topic's evaluation guidance for consolidation by a reporting entity, with specific qualifications and exceptions noted below.

The application of this Topic by not-for-profit entities (NFPs) as defined in Topic 958 is subject to additional guidance in Subtopic 958-810.

The guidance in this Topic applies to all reporting entities, with specific qualifications and exceptions noted below.

The determination of whether a legal entity should be consolidated by a reporting entity begins with an evaluation of whether the legal entity is subject to a general exception to the consolidation requirements in ASC 810-10. If a legal entity is not subject to a general exception, the evaluation should focus on whether the legal entity is subject to an exception to the VIE model. The voting interest entity model is applied only if it is determined that the legal entity qualifies for a VIE scope exception, the legal entity is not a VIE, or the legal entity is not subject to the guidance on consolidation of entities controlled by contract. Evaluating whether a legal entity qualifies for a scope exception or is subject to the VIE model is therefore a critical step in the determination of which consolidation model to apply (i.e., the VIE model or the voting interest entity model).

This chapter provides an overview of considerations related to the initial scope determination and focuses on the general exceptions to the consolidation requirements as well as the VIE scope exceptions. Chapter 5 provides guidance on whether a legal entity is subject to the VIE model (i.e., the legal entity is a VIE).

The VIE model applies to all legal entities that do not qualify for either a general exception to the consolidation requirements or an exception to the application of the VIE model. Accordingly, application of the VIE model is not limited to SPEs. Rather, reporting entities must evaluate all legal entities in which they have an interest to determine whether the legal entities are subject to the VIE subsections. If a scope exception does not apply to a legal entity (SPE or otherwise), reporting entities would be required to evaluate whether the legal entity meets the definition of a VIE. Only if the legal entity qualifies for...
an exception to the application of the VIE subsections, or does not meet the definition of a VIE, would consolidation of the legal entity be evaluated under the voting interest entity model.

### 3.2 Legal Entities

<table>
<thead>
<tr>
<th>ASC 810-10 — Glossary</th>
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</thead>
<tbody>
<tr>
<td><strong>Legal Entity</strong></td>
</tr>
<tr>
<td>Any legal structure used to conduct activities or to hold assets. Some examples of such structures are corporations, partnerships, limited liability companies, grantor trusts, and other trusts.</td>
</tr>
</tbody>
</table>

The scope of the consolidation guidance in ASC 810-10 is limited to a reporting entity’s involvement with another legal entity. The Codification defines “legal entity” relatively broadly; therefore, almost any legal structure that is used to own assets, issue debt, or otherwise conduct activities would meet the definition of a legal entity. The particular legal form of the entity (e.g., a corporation, a partnership, a limited liability company, a grantor trust, or other trust) is not relevant to the determination of whether the entity is a legal entity. Divisions, departments, branches, and pools of assets are examples of entities that are typically not separate legal entities.

A collaborative arrangement that is not conducted via a separate entity is not in itself a legal entity. However, if a separate entity was formed to conduct the activities of a collaborative arrangement, that entity would typically represent a legal entity.

A reporting entity may consider the following factors when evaluating whether a legal entity exists, which will help it determine whether the structure has separate legal standing or identity:

- Do third parties view the structure as a legal entity?
- Does the structure invoice its customers under its own name?
- Do the vendors invoice the structure under its own name?
- Does the structure file a tax return or have a unique identification in any tax jurisdiction?
- Does the structure have separate financial statements?
- Does the structure have any regulatory filing requirements?
- Does the structure have the ability to enter into contracts and agreements?
- Is the structure able to open bank accounts?
- Can the structure be sued or sue others?
- Is the structure able to obtain financing?

Certain industries (such as the asset management industry) commonly use series trusts (referred to herein as a “series”) to permit (1) distinct sets of activities to be legally isolated and conducted separately from one another and (2) each series to benefit from the sharing of administrative and organizational costs. Although there is technically only one umbrella legal entity, each series fund issues its own share class(es) and has characteristics that are substantially the equivalent of operating as a separate entity. Other industries may also use a series or similar legal structure (e.g., segregated cell structures in the insurance industry).
Paragraph BC38 of ASU 2015-02 provides some insight into relevant considerations in the determination of whether an individual series fund is a legal entity. Although the example in the paragraph is specific to an individual series fund, it lists factors that are similar to those above. The FASB noted that it is reasonable to treat an individual series fund as a separate legal entity if the fund is required to comply with the requirements of the Investment Company Act of 1940 (the “1940 Act”) for registered mutual funds, which have the following characteristics:

a. Has its own investment objectives and policies.
b. Has its own custodial agreement.
c. Has its own shareholders separate from other series funds.
d. Has a unique tax identification.
e. Files separate tax returns with the Internal Revenue Service.
f. Has separate audited financial statements.
g. Is considered a separate investment company in virtually all circumstances for purposes of investor protection afforded by the Investment Company Act of 1940 by the Securities and Exchange Commission (SEC) staff’s Division of Investment Management (IM), in accordance with the June 2014 SEC IM staff’s Guidance Update No. 2014-06 titled “Series Investment Companies: Affiliated Transactions.”

The relative weight given to the above characteristics should be based on the relevant facts and circumstances. Reporting entities may need the assistance of legal counsel in determining whether a structure is a legal entity.

### 3.2.1 Evaluating Portions of Legal Entities or Aggregations of Assets Within a Legal Entity as Separate Legal Entities

<table>
<thead>
<tr>
<th>ASC 810-10</th>
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<tbody>
<tr>
<td><strong>15-15</strong> Portions of legal entities or aggregations of assets within a legal entity shall not be treated as separate entities for purposes of applying the Variable Interest Entities Subsections unless the entire entity is a VIE. Some examples are divisions, departments, branches, and pools of assets subject to liabilities that give the creditor no recourse to other assets of the entity. Majority-owned subsidiaries are legal entities separate from their parents that are subject to the Variable Interest Entities Subsections and may be VIEs.</td>
</tr>
</tbody>
</table>

Proper identification of the legal entity being evaluated is critical since it affects all aspects of the consolidation analysis, including whether the legal entity is a VIE or voting interest entity and the nature and extent of any activities that will ultimately be consolidated. For example, before ASU 2015-02, a series was typically not considered a separate legal entity but rather a silo within the broader legal entity (i.e., the umbrella). In many instances, the umbrella would be considered a VIE, and a series (i.e., the silo²) would be consolidated by the asset manager during the period that the manager’s initial seed capital exceeds 50 percent of the economic interests in the series. The asset management industry initially expressed concerns that the ASU would require them to consolidate a series (the silo) at a lower threshold of economic interest (“potentially significant”). Conversely, if a series were to be considered its own legal entity that is evaluated for consolidation under the voting interest entity model, it would be possible for the asset manager to conclude that each series is a separate voting interest entity and that consolidation is required only to the extent that the asset manager has more than 50 percent of the voting interests.

² See Chapter 6 for a discussion of silos.
Generally, a series should be considered its own legal entity under ASC 810-10 if the following three conditions are met:

- **Condition 1** — Essentially all the assets, liabilities, and equity of the larger legal structure reside in individual series, and essentially none of these items reside in the larger legal structure itself.
- **Condition 2** — The assets, liabilities, and equity of each series are legally isolated from the assets, liabilities, and equity of the other series.
- **Condition 3** — Each series presents itself, in all material respects, as a separate legal entity with respect to its dealings with its interest holders and third parties.

The third condition is consistent with the series fund structure discussed by the FASB in paragraphs BC38 and BC39 of ASU 2015-02 (see the introduction to Section 3.2).

Although the Board’s observations in paragraphs BC38 and BC39 are specific to series funds that are registered under the 1940 Act, the requirements under the 1940 Act for such funds (as articulated in paragraph BC38) provide a useful framework for evaluating whether the third condition is present in other structures (e.g., segregated cell companies, unregistered series funds, legal structures in other jurisdictions or industries). In many cases, the evaluation of international series structures may result in a different conclusion from series funds that are registered under the 1940 Act (i.e., that a separate international series should not be considered its own legal entity). A reporting entity should carefully evaluate the characteristics of international funds and use judgment in applying the above factors. For example, although an individual characteristic might not apply to another type of structure (e.g., the entity does not have a unique tax identification because it is located in a nontaxable jurisdiction), the reporting entity should evaluate the relevant factors in the framework in paragraph BC38 to determine whether the series, in substance, represents a separate legal entity.

### 3.2.1.1 SEC Staff Views on International Series Funds as Separate Legal Entities

The Asset Management Accounting Policy Committee of the Securities Industry and Financial Markets Association (SIFMA) and the Asset Management Industry Accounting Policy Group (AMIAPG) formally discussed international series funds with the SEC staff. After those discussions, SIFMA and AMIAPG sent a letter in January 2016 to the SEC staff to confirm the staff’s views on determining whether an international series fund would be considered a separate legal entity under the consolidation models. The letter stated, in part:

> The SEC Staff would not object to the view that the considerations listed in ASU 2015-02, paragraph BC38, be considered indicators as to whether an individual series fund is a legal entity; rather than a prescribed list of criteria that must all be met.

The SEC Staff believes the determination as to whether an individual series fund is a separate legal entity for consolidation purposes requires the application of reasonable judgment and includes, but is not limited to, consideration of the following:

- The definition of a legal entity as defined in the Master Glossary,
- The considerations in paragraph BC38 in the Basis for Conclusions of ASU 2015-02,
- The purpose, objective and strategy of each of the series funds within the umbrella,
- The legal isolation of the assets, liabilities, and equity (i.e., segregation of assets and liabilities) of each of the individual series funds,
• Whether the shareholders of an individual series fund have substantive decision-making rights related to the individual series fund; such rights include, but are not limited to, the ability to directly remove and replace the asset management company for the individual series fund or liquidate the individual series fund, approve the compensation of the asset management company for the individual series fund, and vote on changes to the fundamental investment strategy of the individual series fund, and

• Other relevant jurisdictional characteristics.

The SEC Staff believes that legal isolation of the assets, liabilities and equity of each of the individual series funds and the existence of substantive shareholder decision-making rights at the series fund level can be viewed as relevant and significant considerations in the context of the asset management industry and, as a result, the SEC Staff would expect that in many series fund structures where these two considerations are present, the individual series fund would qualify as a separate legal entity for purposes of the consolidation analysis.

If the individual series fund is considered a legal entity for accounting purposes, the consolidation analysis is performed at the individual series fund level. The SEC Staff would also expect that in such situations, where the shareholders of the individual series fund have substantive decision-making rights, the individual series fund would generally meet the criteria to be classified as a voting interest entity, although such a conclusion would require analysis based on individual facts and circumstances.

It is our understanding that most international series funds are not designed with the substantive decision-making rights listed in the fifth bullet above. If the governance of an international series fund is amended to meet the definition of a separate legal entity, a reporting entity should determine whether substantive decision-making rights are at the series-fund level. We generally expect that a reporting entity's conclusion that a separate legal entity exists would be based on the presence of all the substantive decision-making rights listed by the SEC staff. We believe all of these rights are required in substance but not necessarily in form. For example, if the shareholders could set compensation of the asset manager as low as zero, it may not be relevant that the shareholders do not have an explicit ability to remove and replace the asset manager since setting the compensation to zero may force the asset manager to resign. Therefore, in determining whether a separate legal entity exists, a reporting entity should carefully evaluate the facts and circumstances.

3.2.2 Multitiered Legal-Entity Structures

In a multitiered legal-entity structure, a reporting entity should generally begin its evaluation at the lowest-level entity. Each entity within the structure should then be evaluated on a consolidated basis. The attributes and variable interests of the underlying consolidated entities should generally become those of the parent company upon consolidation.

When a reporting entity applies the VIE model to a consolidated entity, it should analyze the design of the consolidated entity, including an analysis of the risks of the entity, why the entity was created (e.g., the primary activities of the entity), and the variability the entity was designed to create and pass along to its interest holders.

Note that there are situations in which a reporting entity may “look through” a holding company and therefore would not be required to examine the structure on a consolidated basis. For more information, see Section 3.2.3.
### Example 3-1

Two investors each hold 50 percent of the ownership interests in Company H. Company H has 100 percent of the ownership interests in Entity X and consolidates X. Entity X is a business as defined in ASC 805 and represents substantially all of H's consolidated activities and cash flows. Company H, on a stand-alone basis, does not meet the definition of a business in ASC 805. There are no other relationships or agreements between the investors, H, or X.

As noted above, the attributes of a consolidated entity become the attributes of the parent company. In this example, X's attributes become those of H. When the investors are evaluating their ownership interests, they should consider H's design on a consolidated basis. Because X meets ASC 805's definition of a business, and its activities and cash flows represent substantially all of H's consolidated activities and cash flows, H also meets ASC 805's definition of a business. Therefore, the investors in H may be eligible for the business scope exception in ASC 810-10-15-17(d) (see Section 3.4.4). In determining whether any of the four conditions in ASC 810-10-15-17(d) are met, the investors in H should evaluate H's consolidated activities and cash flows, inclusive of X.

### Example 3-2

Two investors each hold 50 percent of the ownership interests in a holding company. The holding company has 100 percent of the ownership interests in Entity E and consolidates E. Entity E meets ASC 805's definition of a business and represents substantially all of the holding company's consolidated activities and cash flows. The holding company also consolidates Entity N, which does not meet ASC 805's definition of a business. Other than its investments in E and N, the holding company has no assets, liabilities, or activities. There are no other relationships or agreements between the investors, the holding company, E, or N.

As in Example 3-1, the attributes of the consolidated entities become those of the parent company. In this example, the attributes of E and N become those of the holding company.

When the investors are evaluating their ownership interests, they should consider the holding company's design on a consolidated basis. Because substantially all of the holding company's consolidated activities and cash flows are derived from E, the holding company meets ASC 805's definition of a business. As in Example 3-1, before applying the business scope exception, the investors must determine whether any of the four conditions in ASC 810-10-15-17(d) have been met regarding the holding company's consolidated activities and cash flows. If so, the business scope exception cannot be applied (see Section 3.4.4).

### Example 3-3

An investor holds 50 percent of the ownership interests in a holding company. The holding company consolidates the following two entities, both of which meet ASC 805's definition of a business:

- Entity J, an operating entity.
- Entity L, whose activities are primarily related to securitizations or other forms of asset-backed financings.

Entity L's activities and cash flows represent substantially all of the holding company's activities and cash flows. Other than its investments in J and L, the holding company has no assets, liabilities, or activities. There are no other relationships or agreements between the investor, the holding company, J, or L.

As in Examples 3-1 and 3-2, the attributes of the consolidated entities become those of the parent company. In this example, the attributes of J and L become those of the holding company.

When the investor is evaluating its ownership interests, it should consider the holding company's design on a consolidated basis. While J and L both meet ASC 805's definition of a business, the investor would not be able to apply the business scope exception because the holding company is designed primarily to facilitate activities that are primarily related to securitizations or other forms of asset-backed financings, which is a scenario in which the business scope exception cannot be applied (see ASC 810-10-15-17(d)(4); also see Section 3.4.4).
Example 3-4

A group of investors establishes a holding company that is 100 percent funded by the equity of the investors. The design and purpose of the company is to hold all the equity of an operating company. The operating company is capitalized as follows: 3 percent by the equity investment from the holding company and 97 percent by non-investment-grade debt. Accordingly, assume that the operating company is a VIE due to insufficiency of equity investment at risk (see Section 5.2). In addition, assume that the holding company consolidates the operating company.

When the investors evaluate whether the holding company is a VIE, they should consider the holding company’s design on a consolidated basis. Because the sole purpose of the holding company was to aggregate investors to control the operating company, the holding company should be considered a VIE due to insufficiency of equity investment at risk (even if the operating company’s debt is nonrecourse to the holding company). That is, it would be inappropriate to ignore the substance of the significant debt at the operating company level and conclude that the holding company is a voting interest entity. The holding company is simply a pass-through for the investors to form the operating company.

Example 3-5

A group of investors establishes a collateralized manager vehicle (CMV) that is funded 100 percent by the equity of the investors. The CMV’s design and purpose is to sponsor, manage, and hold subordinated interests in various CLOs. The CLOs issue debt to third parties on a nonrecourse basis (i.e., the investors in the CLO only have recourse to the performance of the respective CLO). The CLOs are VIEs because they do not have sufficient equity investment at risk. The CMV consolidates the CLOs because the CMV has the power to direct the most significant activities and a potentially significant variable interest through the subordinated interests held.

When the investors are evaluating whether the CMV is a VIE, they should consider the CMV’s design on a consolidated basis. In contrast to Example 3-4, it would not be appropriate to consider the CLOs’ debt in the determination of whether the CMV has sufficient equity investment at risk. The CMV’s design and purpose was to sponsor and manage CLOs rather than to capitalize CLOs, and the CLOs’ debt is nonrecourse to the CMV. That is, despite the CMV’s consolidation of the CLOs (which are VIEs due to insufficient equity investment at risk), we do not believe that the debt issued at the subsidiary CLOs should affect whether the CMV has equity sufficient to finance its activities. Therefore, the equity that is needed to support the activities of the CMV is not at the same level as that needed to capitalize a financing vehicle.

3.2.3 “Looking Through” a Holding Company to the Underlying Legal Entity

Holding companies are frequently established (often for legal or tax purposes) to hold some or all of the ownership interests in a legal entity. In many cases, reporting entities have ownership interests in these holding companies for the sole purpose of investing in an underlying legal entity. Questions can arise about whether a reporting entity with an interest in a holding company can “look through” (i.e., ignore) a holding company and apply the provisions of the VIE model directly to the underlying legal entity as if the holding company does not exist. This is particularly relevant to the business scope exception discussed in Section 3.4.4.

For example, assume that an investor has a 40 percent ownership interest in HoldCo, a holding company that is not a joint venture. HoldCo was designed for the sole purpose of acquiring 100 percent of the ownership interests in Entity X, a preexisting single legal entity that is a business as defined in ASC 805. The investor was involved in the design of HoldCo but was not involved in the design or redesign of X. If the investor cannot look through HoldCo, it cannot apply the business scope exception because the investor was involved in the design of HoldCo (see ASC 810-10-15-17(d)(1)). If the investor can look through HoldCo, it can apply the business scope exception (provided that the investor, X, and HoldCo do not meet any of the other business scope exception conditions) because the investor was not involved in the design or redesign of X.
In limited circumstances, it may be necessary or appropriate for an investor to look through a holding company and apply the VIE model directly to a single underlying legal entity. The investor can only do this when (1) the holding company is a nonsubstantive entity because it does not have any substantive identity separate from that of the underlying legal entity and (2) the economics of the arrangement do not change as a result of the holding company's insertion between the investors and the underlying legal entity.

A holding company is considered to have no substantive identity separate from its investment in the legal entity when all variable interests in the holding company represent indirect variable interests of the reporting entity in the underlying legal entity because they are virtually indistinguishable from direct variable interests of the holding company in the underlying legal entity (i.e., the reporting entity's variable interests in the holding company are essentially “back-to-back” with the holding company's variable interests in the underlying legal entity, and the holding company represents a pass-through entity).

When looking through a holding company is deemed to be appropriate, in general, the conclusions reached under a VIE evaluation (regarding (1) whether a legal entity is a VIE and (2) who consolidates the legal entity as its primary beneficiary) with respect to looking through a holding company should be the same conclusions that would be reached if the analysis were performed separately for the holding company and the underlying legal entity. All facts and circumstances should be considered, including (1) the design of both the holding company and the underlying legal entity and (2) the nature of the relationships with the variable interest holders and their related parties.

Satisfaction of all the following conditions may indicate that a reporting entity can look through a holding company to a single underlying legal entity when applying the VIE model:

- Other than its ownership interests in the single underlying legal entity, the holding company is restricted by its governing documents from holding any assets, issuing debt, or engaging in any operating activities on its own behalf.
- The governing documents of the holding company and the underlying legal entity are substantively the same.
- The governing documents associated with the holding company and the underlying legal entity require that both entities have the same individuals on the board of directors or other bodies that determine the financial and operating policies of the entity.
- Other than tax implications of the holding company, the risks and rewards of the interest holders (including their interests in profits and losses and in liquidation) would be identical if their interests were directly in the underlying legal entity instead of in the holding company.

Example 3-6

An investor holds 40 percent of the ownership interests in a holding company. The holding company has 100 percent of the ownership interests in a single legal entity and consolidates that legal entity. The legal entity is a business as defined in ASC 805. Other than its ownership interests in the legal entity, the holding company has no assets, liabilities, or activities. There are no other relationships or agreements between the investor, the holding company, and the legal entity. Assume that the four conditions described above have been met in this arrangement.

The investor can look through the holding company and apply the VIE model directly to the underlying legal entity because the holding company is a nonsubstantive entity under the VIE subsections. To apply the business scope exception, the investor must determine whether any of the four conditions in ASC 810-10-15-17(d) have been met for either the investor or the single underlying legal entity. If any of the conditions have been met, the business scope exception cannot be applied.
Example 3-7

Assume the same facts as in Example 3-6 except that the holding company takes out a loan from a third-party bank. In this scenario, the investor would not be able to look through the holding company to the underlying legal entity because the holding company's loan precludes the investor from doing so since it has not satisfied the first condition described above (i.e., the holding company is not restricted by its governing documents from holding any assets, issuing debt, or engaging in any operating activities on its own behalf).

Example 3-8

An investor has 40 percent of the ownership interests in a holding company, which holds 100 percent of the ownership interests in a legal entity. The legal entity takes out a loan from a third-party bank. The investor has guaranteed repayment of the loan in the event of default. There are no other relationships or agreements between the investor, the holding company, and the legal entity. Assume that the four conditions described above have been met in this arrangement.

Although not required to do so, the investor would be able to look through the holding company since the investor's guarantee represents a direct variable interest in the legal entity (i.e., the guarantee has no impact on the holding company).

3.3 General Consolidation Scope Exceptions

ASC 810-10

The guidance in this Topic does not apply in any of the following circumstances:

a. An employer shall not consolidate an employee benefit plan subject to the provisions of Topic 712 or 715.

b. Subparagraph superseded by Accounting Standards Update No. 2009-16

c. Subparagraph superseded by Accounting Standards Update No. 2009-16

d. Except as discussed in paragraph 946-810-45-3, an investment company within the scope of Topic 946 shall not consolidate an investee that is not an investment company.

e. A reporting entity shall not consolidate a governmental organization and shall not consolidate a financing entity established by a governmental organization unless the financing entity meets both of the following conditions:
   1. Is not a governmental organization
   2. Is used by the business entity in a manner similar to a VIE in an effort to circumvent the provisions of the Variable Interest Entities Subsections.

f. A reporting entity shall not consolidate a legal entity that is required to comply with or operate in accordance with requirements that are similar to those included in Rule 2a-7 of the Investment Company Act of 1940 for registered money market funds.
   1. A legal entity that is not required to comply with Rule 2a-7 of the Investment Company Act of 1940 qualifies for this exception if it is similar in its purpose and design, including the risks that the legal entity was designed to create and pass through to its investors, as compared with a legal entity required to comply with Rule 2a-7.
2. A reporting entity subject to this scope exception shall disclose any explicit arrangements to provide financial support to legal entities that are required to comply with or operate in accordance with requirements that are similar to those included in Rule 2a-7, as well as any instances of such support provided for the periods presented in the performance statement. For purposes of applying this disclosure requirement, the types of support that should be considered include, but are not limited to, any of the following:

   i. Capital contributions (except pari passu investments)
   ii. Standby letters of credit
   iii. Guarantees of principal and interest on debt investments held by the legal entity
   iv. Agreements to purchase financial assets for amounts greater than fair value (for instance, at amortized cost or par value when the financial assets experience significant credit deterioration)
   v. Waivers of fees, including management fees.

There are four general exceptions to the requirements for consolidating a legal entity. Broadly speaking, the exceptions apply to (1) employee benefit plans, (2) investment companies, (3) governmental entities, and (4) money market funds. If any of these exceptions are applicable, the reporting entity is not required to consolidate the related legal entity under the VIE model or voting interest entity model. As a result, the reporting entity is not required to determine whether the legal entity qualifies for an exception to the application of the VIE model or meets the definition of a VIE. However, as noted above, ASC 810-10 requires a reporting entity to provide certain disclosures when it does not consolidate a legal entity that must comply with or operate in accordance with requirements that are similar to those for registered money market funds included in Rule 2a-7 of the 1940 Act.

3.3.1 Scope Exception for Employee Benefit Plans

Employee benefit plans (either defined benefit or defined contribution) may have significant investments (e.g., equity or debt securities, other investments) in entities that give them a controlling financial interest in those entities through voting rights or other arrangements.

In accordance with the scope exception in ASC 810-10-15-12(a), employee benefit plans subject to ASC 712 or ASC 715 should not be consolidated by the employer-sponsor. However, other parties involved with employee benefit plans, such as service providers, should apply the VIE model, as warranted by the facts and circumstances.

The guidance on an employee benefit plan’s accounting for its investments in other entities is as follows:

- **Defined benefit plans** — ASC 960-325-35-1 states, “Plan investments — whether equity or debt securities, real estate, or other types (excluding insurance contracts) — shall be presented at their fair value at the reporting date.” Since these investments must be carried at fair value, defined benefit plans should not apply the consolidation requirements in ASC 810-10.

- **Other employee benefit plans** — For other employee benefit plans (defined contribution plans, employee health and welfare benefit plans), the guidance in ASC 962 and ASC 965, respectively, applies. Because that guidance generally requires that investments be carried at fair value (see ASC 962-325-35-1 and ASC 965-325-35-1), the consolidation requirements in ASC 810-10 would not apply to other employee benefit plans.

Nonleveraged employee stock ownership plans (ESOPs), which are defined contribution plans, are within the scope of ASC 718. Since the guidance on such plans is similar to that in ASC 715, we believe that a plan sponsor may apply the employee benefit plan scope exception to them. In addition, even though
the accounting for leveraged ESOPs under ASC 718 is not similar to that in ASC 715, because such
ESOPs are defined contribution plans, a plan sponsor should apply the employee benefit plan scope
exception to them as well.

Note that rabbi trusts do not meet the criteria to qualify for the employee benefit plan scope exception
and should be assessed for consolidation under ASC 810-10. Generally, such trusts are VIEs because
they have no equity and are only a liability to employees. However, in situations in which these trusts do
have equity, they would often still be VIEs because the equity investment was provided by the employer
to the employee in exchange for services and therefore was not at risk under ASC 810-10-15-14(a)(3).
If the accounts of a rabbi trust are not VIEs, they should be consolidated in the employer's financial
statements under ASC 710-10-45-1.

3.3.2 Scope Exception for Investment Companies

ASC 810-10-15-12(d) prohibits a reporting entity that qualifies as an investment company under ASC 946
from consolidating an investee that is not an investment company unless the investee is an operating
entity that provides services to the investment company. (Note that if a reporting entity is exempt from
consolidating an investee, it would also be exempt from the disclosure requirements in ASC 810 related
to the investments.) Investment companies account for their investments in noninvestment companies
(other than those that are providing a service to the investment company) at fair value in accordance
with the specialized accounting guidance in ASC 946.

The interpretive guidance in Volume II of the Reporting Standards Handbook issued by the National
Council of Real Estate Investment Fiduciaries’ Pension Real Estate Association discusses two different
presentation models for real estate reporting entities that qualify as investment companies under ASC
946: (1) the nonoperating model, which is aligned with the accounting for investments specified in ASC
946 and is based on the amount, measured at fair value, invested by the investment company and
(2) the operating model, under which the reporting entity presents the gross fair value of the real estate
and the liabilities along with the associated real estate revenues and expenses.

Under the scope exception in ASC 810-10-15-12(d), an investment company technically should not
consolidate an investee that is not an investment company unless the investee is an operating entity
that provides services to the investment company. However, we believe that a real estate reporting
entity that qualifies as an investment company and prepares its financial statements under the
operating model should, by analogy, perform a full consolidation analysis under ASC 810, including an
evaluation of whether the investee is a VIE, to determine whether it has a controlling financial interest in
the investee and therefore whether consolidation under the operating model is appropriate.

The scope exception in ASC 810-10-15-12(d) does not apply to any of the following:

- A reporting entity that is not an investment company under ASC 946 that has an interest in an
  investment company.
- A reporting entity that is not an investment company under ASC 946 that applies fair value
  accounting to its investments.
- A reporting entity that is an investment company under ASC 946 that has an interest in an
  operating entity that provides services to the investment company (e.g., an investment adviser
  or transfer agent).
- A reporting entity that is an investment company under ASC 946 that has an interest in another
  investment company.
In the situations above, unless the reporting entity qualifies for another exception in ASC 810-10-15-12 or an exception to the application of the VIE model in ASC 810-10-15-17 and as long as the investee is a VIE in accordance with ASC 810-10-15-14, the reporting entity would apply the VIE model in evaluating its accounting for the investee. See further discussion of these situations below.

### 3.3.2.1 A Reporting Entity That Is Not an Investment Company Under ASC 946 That Has an Interest in an Investment Company

A noninvestment company reporting entity is required to evaluate whether it should consolidate an investee that is an investment company under ASC 946 unless the investment company qualifies for the exception for money market funds in ASC 810-10-15-12(f). If the reporting entity’s interest does not qualify for any of the exceptions to the application of the VIE model, the reporting entity is required to determine whether the investment company is a VIE. If the investment company is a VIE, the reporting entity should apply the VIE model; otherwise, the reporting entity should evaluate the investment company for consolidation under the voting interest entity model in ASC 810-10.

As noted in ASC 810-10-25-15, a noninvestment company parent retains the specialized accounting applied by an investment company subsidiary in consolidation.

**Example 3-9**

Entity XYZ is a legal entity that was established by Entity A and Entity B (not investment companies) to invest in debt and equity securities of technology startup companies. Entity XYZ intends to own the debt and equity securities for capital appreciation and investment income purposes. Furthermore, A and B do not intend to obtain benefits from XYZ other than capital appreciation or investment income, and XYZ meets the other conditions in ASC 946 to be accounted for as an investment company. In establishing XYZ, A acquired 50 percent of the common equity of XYZ, B acquired 40 percent of the common equity of XYZ, and the remaining 10 percent of common equity of XYZ was sold to other unrelated investors.

Both A and B would have to evaluate whether XYZ is a VIE under ASC 810-10-15-14. Entity XYZ does not qualify for the exception in ASC 810-10-15-12(d) and does not qualify for any of the exceptions to the application of the VIE model in ASC 810-10-15-17 (the business scope exception does not apply).

Note that if either A or B consolidated XYZ under ASC 810-10, its consolidated financial statements should reflect the specialized industry accounting principles that apply to XYZ. That is, in A’s or B’s consolidated financial statements, XYZ’s investments should be accounted for at fair value with changes in fair value reported in a statement of operations or financial performance.

**Example 3-10**

Entity X is a general partner in Entity Y, a limited partnership. Entity Y is considered an investment company under ASC 946, and it records its investments at fair value with changes in fair value reported in a statement of operations or changes in net assets. Entity X is not considered an investment company.

Entity X cannot apply the scope exception in ASC 810-10-15-12(d) to its investment in Y because X is not an investment company; X must therefore consider whether it is required to consolidate Y under ASC 810-10.

Note that if X consolidated Y under ASC 810-10, its consolidated financial statements should reflect the specialized industry accounting principles that apply to Y. That is, in X’s consolidated financial statements, Y’s investments should be accounted for at fair value with changes in fair value reported in a statement of operations or financial performance.
3.3.2.2  A Reporting Entity That Is Not an Investment Company Under ASC 946 That Applies Fair Value Accounting to Its Investments

ASC 946 does not address the accounting for reporting entities that are not investment companies. Accordingly, reporting entities that are not investment companies within the scope of ASC 946 (and do not qualify for any other general scope exception) should evaluate their investees to determine whether they are VIEs if they do not qualify for a VIE scope exception under ASC 810-10-15-17. It would not be appropriate for a reporting entity to elect the fair value option in lieu of consolidating a legal entity that requires consolidation under ASC 810-10. As noted in ASC 825-10-15-5(a), the fair value option may not be applied to an “investment in a subsidiary that the entity is required to consolidate.”

3.3.2.3  A Reporting Entity That Is an Investment Company Under ASC 946 That Has an Interest in an Operating Entity That Provides Services to the Investment Company

ASC 946-810-45-3 indicates that when an investment company has a controlling financial interest in an operating entity that provides services to the investment company, the investment company should consolidate the operating entity. The FASB believes that in those cases, “the purpose of the investment is to provide services to the investment company rather than to realize a gain on the sale of the investment.” Accordingly, when an investment company has an interest in an operating entity that provides services to the investment company, the investment company should evaluate whether the investment would qualify for an exception to the application of the VIE subsections of ASC 810-10. If no such exception is appropriate, the investment company is required to determine whether the operating entity is a VIE. If the operating entity is a VIE, the investment company should apply the VIE model; otherwise, the investment company should evaluate the operating entity for consolidation under the voting interest entity model.

3.3.2.4  A Reporting Entity That Is an Investment Company Under ASC 946 That Has an Interest in Another Investment Company

While ASC 946 generally prohibits an investment company from consolidating an operating entity, it does not provide guidance on whether the investment company should consolidate another investment company.

In October 2014, the SEC’s Division of Investment Management released Guidance Update No. 2014-11, which provides the views of the Division's Chief Accountant's Office regarding the presentation of consolidated financial statements of certain investment companies registered under the 1940 Act, including feeder funds in a master-feeder structure, funds of funds, and business development companies. The Guidance Update highlights that for feeder funds in master-feeder structures and funds of funds, the staff has generally held the view that unconsolidated financial statement presentation is the most meaningful presentation for users. However, the staff has generally suggested that a business development company should consolidate its wholly owned subsidiaries that have been established to invest in portfolio companies when “the design and purpose of the subsidiary (e.g., a holding company) may be to act as an extension of the [business development company’s] investment operations and to facilitate the execution of the [business development company’s] investment strategy.”

For situations not described in the Guidance Update, we believe that an investment company should consolidate another investment company over which it has a controlling financial interest. Therefore, unless it qualifies for an exception to the application of the VIE subsections of ASC 810-10 under ASC 810-10-15-17, the investment company reporting entity should evaluate whether the investment company investee is a VIE. However, we understand that there may be diversity in practice in these circumstances and that consolidation may not be commonly applied when the nature of the investment
is for capital appreciation, investment income, or both. Therefore, consultation with independent accountants is strongly encouraged.

3.3.2.5 ASC 810-10 Disclosures Not Required When Investment Company Qualifies for Exception

ASC 810-10-15-12 indicates that the guidance in ASC 810-10 “does not apply” when a legal entity qualifies for the exception in ASC 810-10-15-12(d). Thus, none of the ASC 810-10 disclosures apply to investment companies that qualify for that exception.

ASC 810-10-15-17(b) states that “[s]eparate accounts of life insurance entities as described in [ASC] 944 are not subject to consolidation according to the requirements of the Variable Interest Entities Subsections.” In paragraph E11 of FIN 46(R), the FASB clarified its intent to exclude separate accounts from the guidance now codified in ASC 810. Paragraph E11 states:

Separate accounts of life insurance enterprises are excluded from the scope of this Interpretation because existing accounting standards specifically require life insurance enterprises to recognize those accounts and the Board chose not to change those requirements without a broader reconsideration of accounting by [life] insurance enterprises. [Emphasis added]

Although the FASB did not provide similar clarification with respect to investments subject to the specialized accounting guidance in ASC 946, the basis for the two scope exceptions is essentially the same. It is therefore reasonable to conclude that the FASB’s intent was similar for both exceptions (i.e., that when an investment company qualifies for the exception in ASC 810-10-15-12(d), none of the ASC 810-10 disclosures apply to the investee).

3.3.3 Scope Exception for Governmental Organizations

The scope exception in ASC 810-10-15-12(e) states that a reporting entity “shall not consolidate a governmental organization [or] a financing entity established by a governmental organization unless the financing entity [is] not a governmental organization [and is used] in a manner similar to a VIE in an effort to circumvent the provisions” of the VIE model. The exception applies to nongovernmental reporting entities involved with a governmental organization or financing entities established by a governmental organization. In the absence of this scope exception, governmental entities could be considered VIEs because of their lack of equity at risk, and nongovernmental reporting entities could be identified as the primary beneficiary of the governmental entity, which was not the FASB’s intent.

3.3.3.1 Definition of a “Governmental Organization”

The AICPA Audit and Accounting Guide State and Local Governments and the GASB staff paper Applicability of GASB Standards are helpful in understanding the term “governmental organization” as contemplated in ASC 810-10-15-12(e).

Paragraph 1.01 of State and Local Governments defines governmental organization as follows:

Public corporations and bodies corporate and politic are governmental organizations. Other organizations are governmental if they have one or more of the following characteristics:

• Popular election of officers or appointment (or approval) of a controlling majority of the members of the organization’s governing body by officials of one or more state or local governments;

• The potential for unilateral dissolution by a government with the net assets reverting to a government [without compensation by that government]; or

• The power to enact and enforce a tax levy.
Furthermore, organizations are presumed to be governmental if they have the ability to issue directly (rather than through a state or municipal authority) debt that pays interest exempt from federal taxation. However, organizations possessing only that ability (to issue tax-exempt debt) and none of the other governmental characteristics may rebut the presumption that they are governmental if their determination is supported by compelling, relevant evidence. [Footnote omitted]

Paragraph 3 of *Applicability of GASB Standards* lists additional factors that should be considered in the determination of whether an entity is a governmental organization, including the following:

- Legal decisions that provide the entity with the privileges or responsibilities of government.
- Classification as government by the U.S. Bureau of Census.
- Evidence of managerial control by a governmental entity (e.g., ability to designate day-to-day operating management, imposition by statute of day-to-day operating requirements).
- Possession of other sovereign powers.
- Exemption of income from federal taxation through revenue rulings based on the governmental character of the entity.
- If acquired rather than created by a government, the purpose of the acquisition and its expected permanence.

### 3.3.3.2 Whether a Financing Entity Established by a Governmental Organization Was Used to Circumvent the Provisions of the VIE Model

The governmental organization scope exception does not apply if a financing entity established by a governmental organization is being used by a nongovernmental entity to circumvent the consolidation requirements under the VIE model. To determine whether a governmental organization is being used in this way, a reporting entity would apply significant judgment and consider a number of factors related to the purpose and design of the legal entity, including:

- Why the potential VIE was created.
- The activities of the potential VIE.
- The extent of involvement by the reporting entity in the activities of the potential VIE.
- The nature of the potential VIE's interests issued.

In general, if a governmental organization establishes a legal entity to issue tax exempt debt or provide tax subsidies to a reporting entity, the purpose of the legal entity would not have been to circumvent the consolidation requirements under the VIE model, even if the reporting entity is the only party other than the bond holders contracting with the legal entity.

**Example 3-11**

A U.S. city (considered a governmental organization) establishes and manages a nongovernmental entity to purchase a water treatment plant. The entity issues debt to finance the plant's acquisition. The debt is purchased by several unrelated third-party private investors, institutional investors, or both. The entity is established on behalf of and for the benefit of the U.S. city, and the investors are not involved in any activities of the entity. In the absence of evidence to the contrary, the investors would be able to apply the scope exception for governmental organizations because (1) the entity was set up on behalf of and for the benefit of the U.S. city, (2) the U.S. city manages the entity, and (3) interests held by the investors do not allow the investors to be involved in the activities of the entity.
Example 3-12

A local governmental entity establishes a trust to issue bonds to finance the construction of a corporate office building for Company A. The bonds are purchased by third parties, the trust enters into a lease with A, and at the end of the lease, the property reverts to A. The sole purpose of the establishment of the trust by the local government is to facilitate tax subsidies for A as an incentive to move its corporate office to the local municipality. Because the trust was established for valid tax purposes, in the absence of evidence to the contrary, A would be able to apply the government scope exception to the trust.

3.3.4 Scope Exception for Money Market Funds and Other Similar Entities

A legal entity that is required to comply with or operate in accordance with requirements that are similar to those included in Rule 2a-7 of the 1940 Act for registered money market funds should not be evaluated for consolidation under either the voting interest entity model or the VIE model. These entities are outside of the scope of the consolidation requirements in ASC 810-10. However, a reporting entity that qualifies for use of this scope exception is required to disclose information about financial support provided to money market funds managed by the reporting entity, regardless of whether such funds were historically consolidated or would be consolidated under the requirements in ASC 810-10. Accordingly, additional disclosures would be required when, for example, a reporting entity has waived its management fees. See Section 11.2.5.2 for further discussion of the disclosure requirements related to money market funds.

3.3.4.1 Nonregistered Money Market Funds

The scope exception in ASC 810-10-15-12(f) may be applied to a legal entity that is not a registered money market fund under the 1940 Act only if the legal entity has requirements similar to those in Rule 2a-7 of the 1940 Act.

While all facts and circumstances need to be considered, unregistered money market funds (either domestic or foreign) that qualified for the money market fund deferral in ASU 2010-10 will generally qualify for the money market scope exception in ASC 810-10-15-12(f). The FASB notes in paragraph BC78 of ASU 2015-02 that its decision to provide an exemption for funds that are required to comply with Rule 2a-7 and those that operate in a manner similar to registered money market funds “in effect, made permanent for certain money market funds the indefinite deferral of Statement 167 provided in the amendments in [ASU] 2010-10.” In addition, paragraph BC81 indicates that while the Board provided additional language in the scope exception to clarify the meaning of the term “similar,” it does not expect this language to change the way the indefinite deferral is currently applied.

When assessing whether a fund is considered to operate in accordance with requirements similar to those in Rule 2a-7, the reporting entity should evaluate the purpose and design of that fund, including the risks that the fund was designed to create and pass along to its investors. This would include evaluating (1) the fund’s investment portfolio quality, (2) the portfolio maturity and diversification, and (3) the ability of investors to redeem their interests. That is, to qualify for the scope exception, the fund would need to invest in a diverse portfolio of high-quality, short-term securities that are a low credit risk.
### 3.4 Scope Exceptions From the VIE Model

**ASC 810-10**

**15-17** The following exceptions to the Variable Interest Entities Subsections apply to all legal entities in addition to the exceptions listed in paragraph 810-10-15-12:

- **a.** Not-for-profit entities (NFPs) are not subject to the Variable Interest Entities Subsections, except that they may be related parties for purposes of applying paragraphs 810-10-25-42 through 25-44. In addition, if an NFP is used by business reporting entities in a manner similar to a VIE in an effort to circumvent the provisions of the Variable Interest Entities Subsections, that NFP shall be subject to the guidance in the Variable Interest Entities Subsections.

- **b.** Separate accounts of life insurance entities as described in Topic 944 are not subject to consolidation according to the requirements of the Variable Interest Entities Subsections.

- **c.** A reporting entity with an interest in a VIE or potential VIE created before December 31, 2003, is not required to apply the guidance in the Variable Interest Entities Subsections to that VIE or legal entity if the reporting entity, after making an exhaustive effort, is unable to obtain the information necessary to do any one of the following:
  1. Determine whether the legal entity is a VIE
  2. Determine whether the reporting entity is the VIE’s primary beneficiary
  3. Perform the accounting required to consolidate the VIE for which it is determined to be the primary beneficiary.

  This inability to obtain the necessary information is expected to be infrequent, especially if the reporting entity participated significantly in the design or redesign of the legal entity. The scope exception in this provision applies only as long as the reporting entity continues to be unable to obtain the necessary information. Paragraph 810-10-50-6 requires certain disclosures to be made about interests in VIEs subject to this provision. Paragraphs 810-10-30-7 through 30-9 provide transition guidance for a reporting entity that subsequently obtains the information necessary to apply the Variable Interest Entities Subsections to a VIE subject to this exception.

- **d.** A legal entity that is deemed to be a business need not be evaluated by a reporting entity to determine if the legal entity is a VIE under the requirements of the Variable Interest Entities Subsections unless any of the following conditions exist (however, for legal entities that are excluded by this provision, other generally accepted accounting principles [GAAP] should be applied):
  1. The reporting entity, its related parties (all parties identified in paragraph 810-10-25-43, except for de facto agents under paragraph 810-10-25-43(d)), or both participated significantly in the design or redesign of the legal entity. However, this condition does not apply if the legal entity is an operating joint venture under joint control of the reporting entity and one or more independent parties or a franchisee.
  2. The legal entity is designed so that substantially all of its activities either involve or are conducted on behalf of the reporting entity and its related parties.
  3. The reporting entity 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 legal entity based on an analysis of the fair values of the interests in the legal entity.
  4. The activities of the legal entity are primarily related to securitizations or other forms of asset-backed financings or single-lessee leasing arrangements.

A legal entity that previously was not evaluated to determine if it was a VIE because of this provision need not be evaluated in future periods as long as the legal entity continues to meet the conditions in (d).
A reporting entity that has an interest in a legal entity should first evaluate whether it qualifies for a general scope exception to the consolidation requirements in ASC 810-10-15-12 (see Section 3.3). If it does not, it should determine whether it qualifies for any of the following four scope exceptions to application of the VIE model:

1. Not-for-profit entities (NFPs).
2. Separate accounts of life insurance entities.
3. Exhaustive efforts.

### 3.4.1 Scope Exception for NFPs

Like the governmental organization scope exception in ASC 810-10-15-12(e), a for-profit entity is exempt from consolidating an NFP under the VIE model unless the NFP is used in a manner similar to a VIE and the intent is to circumvent the provisions of the VIE model (see Section 3.4.1.2 for guidance on identifying circumvention of the VIE model). However, a for-profit entity should evaluate an NFP under the voting interest entity model. Under the voting interest entity model (see Appendix D), a for-profit entity would generally consolidate an NFP if (1) it holds an economic interest in the NFP and (2) the for-profit entity is the sole corporate member or controls the board of directors. All facts and circumstances should be considered, including the existence of kick-out or participating rights.

In addition, an NFP is not required to determine, under the VIE model, whether to consolidate any legal entity in which it holds an interest. However, the NFP may be a related party of a for-profit entity that must be analyzed pursuant to the guidance in ASC 810-10 on related parties (see Chapter 8). See Section 3.4.1.3 for additional guidance on the consolidation model for NFPs.

### 3.4.1.1 Certain Situations in Which an Entity Does Not Qualify for the NFP Scope Exception

The ASC master glossary defines an NFP as:

An entity that possesses the following characteristics, in varying degrees, that distinguish it from a business entity:

- Contributions of significant amounts of resources from resource providers who do not expect commensurate or proportionate pecuniary return
- Operating purposes other than to provide goods or services at a profit
- Absence of ownership interests like those of business entities.

Entities that clearly fall outside this definition include the following:

- All investor-owned entities
- Entities that provide dividends, lower costs, or other economic benefits directly and proportionately to their owners, members, or participants, such as mutual insurance entities, credit unions, farm and rural electric cooperatives, and employee benefit plans.

Only entities that meet the Codification's definition of an NFP can qualify for the NFP scope exception inASC 810-10-15-17(a). Accordingly, an entity that presents its financial statements in a manner similar to an NFP, but does not meet the Codification's definition of an NFP, does not qualify for the NFP scope exception. Further, an entity that qualifies as an NFP for regulatory purposes (e.g., under state law), but does not meet the Codification's definition of an NFP, does not qualify for the NFP scope exception.
Example 3-13

Company A (a for-profit organization) sells properties to a common interest realty association (CIRA) in exchange for time-share memberships, which A then sells to consumers. The CIRA presents its financial statements similarly to an NFP pursuant to ASC 972 but does not meet the Codification's definition of an NFP.

We understand that the SEC staff does not believe that a CIRA is an NFP because typically it does not meet part (a) or part (c) of the Codification's definition as follows:

- **Part (a)** — The investors (consumers who purchase the time-share units) expect the CIRA to use their contributions to maintain the properties, which maintains (or increases) the value of their time-share units.
- **Part (c)** — The investors have a residual claim on the properties and voting rights with respect to the activities of the CIRA, and the units are exchangeable. These attributes are characteristics of “ownership interests like those of business entities.”

The CIRA, therefore, would not meet the scope exception for NFPs in ASC 810-10-15-17(a).

Note that the next steps in applying the VIE model are to determine whether A has a variable interest and whether the CIRA entity is a VIE.

3.4.1.2 Use of an NFP in Circumvention of the VIE Model

ASC 810-10-15-17(a) states that if a business reporting entity uses an NFP to circumvent the provisions of the VIE model, the NFP is subject to the VIE model. The determination of whether an NFP has been established to circumvent the VIE model requires significant judgment. As part of this analysis, a reporting entity should consider all facts and circumstances associated with the creation and design of the NFP as well as the NFP’s relationship with business entities. For example, a reporting entity should consider the following:

- Whether the party (the sponsor) who will transact with the NFP created or designed the legal entity.
- Why the legal entity was formed as an NFP.
- The nature of the NFP’s operations (e.g., whether substantially all of its activities are on behalf of the sponsor).

Example 3-14

Enterprise A, a business enterprise, establishes Entity B, an NFP whose sole purpose is to lease a building to A. To purchase this building, B uses the proceeds of various tranches of senior and subordinated debt it has issued. The terms of the lease are designed so that A can attain operating lease treatment. The terms include a first-loss residual value guarantee from A (the guarantee is capped to meet the operating lease criteria), and A has a fixed-price purchase option at the end of the lease term (the option is not considered to be a bargain purchase option). It is expected that all of the lease payments (including those from the residual value guarantee) and the proceeds from final sale of the property will be sufficient to redeem the debt. Although no excess funds are expected after the debt is redeemed, any excess funds must be contributed to a local foundation.

In the absence of a valid business purpose, A cannot use the NFP scope exception in analyzing whether it must consolidate B because the form of B as an NFP was used simply to circumvent the provisions of the VIE model. Therefore, A would need to analyze its arrangement with B under the VIE model.
3.4.1.3  **Accounting Guidance for NFPs That Are Outside the Scope of ASC 810-10**

NFPs that qualify for the scope exception in ASC 810-10-15-17(a) should apply ASC 958 and ASC 954 instead of ASC 810-10. See Section E.6 for detailed guidance and interpretations for NFPs.

3.4.1.4  **Retention of a For-Profit Reporting Entity’s Accounting Policies in the Consolidated Financial Statements of an NFP Reporting Entity**

For-profit reporting entities that are owned by NFP reporting entities must apply the VIE model to a legal entity in which it holds an interest. That guidance does not change as a result of consolidation of the for-profit entity by the NFP reporting entity. This position is supported by analogy to ASC 810-10-25-15, which states:

> For the purposes of consolidating a subsidiary subject to guidance in an industry-specific Topic, an entity shall retain the industry-specific guidance applied by that subsidiary.

**Example 3-15**

Company N, a not-for-profit health care company that applies the guidance in ASC 954, has a wholly owned subsidiary, W, a for-profit holding company that directly operates several for-profit businesses. Company W has a variable interest in Company V and consolidates V under the provisions of the VIE model. While ASC 810-10-15-17(a) exempts N from the provisions of the VIE model, W’s accounting for V should be retained in the consolidated financial statements of N (a not-for-profit reporting entity).

3.4.2  **Scope Exception for Separate Accounts of Life Insurance Entities**

ASC 810-10-15-17(b) exempts life insurance entities and the investors in the separate accounts of life insurance entities from applying the VIE model to a separate account of the life insurance company. However, a separate account must nevertheless apply the VIE model to a legal entity in which it holds a variable interest. That is, when financial statements of a separate account are separately prepared in accordance with GAAP, the financial statements of the separate account are not exempt from the guidance in the VIE subsections.

The scope exception in ASC 810-10-15-17(b) applies to investors in assets held by a separate account of an insurance company. The insurance company would apply the guidance in ASC 944-80-45-1, which states, in part, that “[s]eparate account assets and liabilities shall be included in the financial statements of the insurance entity.” The FASB included this scope exception because it did not intend to change the accounting under ASC 944.

In April 2010, the FASB issued ASU 2010-15, which addresses, among other things, whether an insurance company is required to consolidate a majority-owned investment when such investment is held through the insurance company’s separate accounts (as described in ASC 944-80-25-2) or through a combination of investments in the insurance company’s separate and general accounts. The ASU states that “an insurance entity should not consider any separate account interests held for the benefit of policy holders in an investment to be the insurer’s interests and should not combine those interests with its general account interest in the same investment when assessing the investment for consolidation, unless the separate account interests are held for the benefit of a related party policy holder.” In addition, ASU 2010-15 specifies that in the determination of whether specialized accounting for investments in consolidation should be retained (note that separate accounts that issue stand-alone financial statements are generally considered investment companies), a separate account should be viewed to be the equivalent of a **subsidiary** (i.e., separate legal entity) even though separate accounts are generally not set up as separate legal entities by the insurance company. Since ASC 810-10-15-12(d) precludes investment companies from consolidating noninvestment companies
(with certain exceptions), viewing the separate account as an investment company would generally prevent the insurance company from consolidating an investment in which a separate account holds a controlling financial interest.

3.4.3 Scope Exception for Exhaustive Efforts for Entities Created Before December 31, 2003

In determining whether the exception in ASC 810-10-15-17(c) may be applied, a reporting entity should consider all facts and circumstances associated with its ability to obtain information from a legal entity in which it has an interest. ASC 810-10-15-17(c) states, in part, that the “inability to obtain the necessary information is expected to be infrequent, especially if the reporting entity participated significantly in the design or redesign of the legal entity.”

Therefore, a reporting entity that concludes it is subject to this exemption should compile documentation demonstrating that it has made a significant effort to obtain the information (e.g., date, time, and nature of requests; evidence that the appropriate parties at the legal entity have been contacted; copies of requests for written information; evidence that other holders of similar variable interests are also unable to obtain the information; the nature of any responses from the legal entity). A reporting entity is not required to resort to legal action to obtain information if it does not have a contractual right to obtain the information.

The reporting entity should make an exhaustive effort, supported by appropriate documentation, for each legal entity to which it is unable to apply the VIE model. As long as the reporting entity has an interest in the legal entity in question, the reporting entity should continue to make exhaustive efforts to obtain the necessary information no less frequently than each reporting period.

At the 2004 AICPA Conference on Current SEC and PCAOB Developments, the SEC staff emphasized that management should be prepared to support how it has satisfied the exhaustive-effort requirements.

Note that reporting entities can apply this scope exception only for legal entities created before December 31, 2003.

At the 2003 AICPA Conference on Current SEC Developments, the SEC staff stated the following:

[T]he staff has begun to contemplate the meaning of “an exhaustive effort” in applying this limited scope exception. Consistent with the thoughts of the FASB, as expressed in the modifications to FIN 46 [codified in ASC 810-10], the staff anticipates that the use of the exception will be infrequent. We plan to deal with instances where the information scope exception is being applied on a case-by-case basis, considering all of the relevant facts and circumstances. In assessing those facts and circumstances, the staff can be expected to consider whether registrants operating in the same industry with similar types of arrangements were able to obtain the requisite information.

ASC 810-10-50-6 requires that certain disclosures be made about interests in VIEs that apply this provision. (See Section 11.2.5.1 for further discussion of the disclosure requirements related to the exhaustive-efforts scope exception.) ASC 810-10-30-7 provides transition guidance for a reporting entity that subsequently obtains the information necessary to apply the VIE model to an entity previously subject to this exception.
3.4.3.1 Application of the Exhaustive-Efforts Scope Exception to an Inactive Entity Created Before December 31, 2003

The exhaustive-efforts scope exception in the VIE model applies only when (1) a legal entity was created before December 31, 2003, and (2) the reporting entity meets the other requirements of ASC 810-10-15-17(c). A legal entity may have been created before December 31, 2003, remained inactive for a number of years, and then been activated after December 31, 2003, to carry out new activities and issue new variable interests. In these situations, the exhaustive-efforts scope exception may not be applied. At the 2003 AICPA Conference on Current SEC Developments, the SEC staff stated the following:

For instance, in making a determination whether to apply the scope exception, registrants should carefully consider whether the entity was really created prior to December 31st or was merely in existence prior to that date and re-configured in such a way that the “creation date” of the legal entity is not relevant. For instance, if an entity was inactive for a number of years and then re-activated after December 31st to carry out new activities and issue new variable interests, the staff would consider the use of the information scope exception abusive.

3.4.4 Scope Exception for Entities That Meet the Definition of a Business

The FASB has indicated that determining whether a legal entity is a business is not, in and of itself, relevant to the VIE model's consolidation objective. The VIE model focuses on the identification of entities for which an analysis of voting interests is not effective in the determination of whether a controlling financial interest is held by a reporting entity. The business scope exception is thus intended to specify conditions that would help identify legal entities in which voting interests would be effective in the determination of whether a controlling financial interest in the legal entity is held by the reporting entity. Accordingly, the FASB created conditions that, if none are met, would obviate the need for further analysis of whether the legal entity should be consolidated pursuant to the VIE model.

The business scope exception is two-pronged and premised on both (1) the legal entity's characteristics (i.e., whether it is a business, and its activities) and (2) the reporting entity's relationship with the legal entity (i.e., the extent of involvement by the reporting entity in the design or redesign of the legal entity, whether the legal entity is designed so that substantially all of its activities either involve or are conducted on behalf of the reporting entity and its related parties, and whether the reporting entity and its related parties provided more than half of the subordinated financial support). A common oversight in evaluating the applicability of the business scope exception is merely assessing whether a legal entity meets the definition of a business and failing to determine whether any of the four conditions in ASC 810-10-15-17(d) are met.

The first three conditions in ASC 810-10-15-17(d) focus on the reporting entity's relationship with the legal entity and can help reporting entities identify whether legal entities have relationships that are so intertwined with the reporting entity that it would be inappropriate to exclude them from the VIE model merely because they meet the definition of a business. In the fourth condition, the activities of the legal entity itself are considered. If the legal entity does not meet the definition of a business, or is a business but meets any of the following four conditions, the legal entity would not qualify for the business scope exception. ASC 810-10-15-17(d) states, in part:

1. The reporting entity, its related parties (all parties identified in paragraph 810-10-25-43, except for de facto agents under paragraph 810-10-25-43(d)), or both participated significantly in the design or redesign of the legal entity. However, this condition does not apply if the legal entity is an operating joint venture under joint control of the reporting entity and one or more independent parties or a franchisee.
2. The legal entity is designed so that substantially all of its activities either involve or are conducted on behalf of the reporting entity and its related parties.
3. The reporting entity 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 legal entity based on an analysis of the fair values of the interests in the legal entity.

4. The activities of the legal entity are primarily related to securitizations or other forms of asset-backed financings or single-lessee leasing arrangements.

### 3.4.4.1 Applying the Business Scope Exception on a Reporting-Entity-by-Reporting-Entity Basis

The business scope exception should be evaluated on a reporting-entity-by-reporting-entity basis. Each reporting entity involved with the legal entity must evaluate whether the legal entity (or reporting entity) meets any of the conditions in ASC 810-10-15-17(d) and thus fails to qualify for the scope exception. It is possible that one reporting entity with an interest in a legal entity will fail to qualify for this scope exception while another reporting entity with an interest in the same legal entity will qualify.

A determination of whether the following conditions have been met should be based on an analysis of the legal entity (and thus the same analysis should be used for all holders of interests in the legal entity):

- Whether the legal entity is a business as defined in ASC 805 (see Section 3.4.4.2).
- Whether the activities of the legal entity are primarily related to securitizations or other forms of asset-backed financings or single-lessee leasing arrangements (see ASC 810-10-15-17(d)(4); also see Section 3.4.4.11 for more information about single-lessee leasing activities).

A determination of whether the following conditions have been met should be based on an analysis of the relationship each interest holder (reporting entity) and its related parties have with the legal entity (the results of the analysis may, therefore, be different for different holders of interests in the legal entity):

- Whether the reporting entity, its related parties (for this purpose includes all related parties in ASC 810-10-25-43, except for de facto agents under ASC 810-10-25-43(d)), or both participated significantly in the design or redesign of the legal entity, unless the legal entity is an operating joint venture under joint control of the reporting entity and one or more independent parties or a franchisee (ASC 810-10-15-17(d)(1)).
- Whether the legal entity is designed so that substantially all of its activities either involve or are conducted on behalf of the reporting entity and its related parties (ASC 810-10-15-17(d)(2)).
- Whether the reporting entity and its related parties provide more than half the total of the equity, subordinated debt, and other forms of subordinated financial support to the legal entity (ASC 810-10-15-17(d)(3)).

### Example 3-16

A joint venture (Entity A) is formed by two enterprises. Entity A meets the definition of a business in ASC 805 and does not meet the condition in ASC 810-10-15-17(d)(4). Enterprise 1 provides 50 percent of the equity and a subordinated loan to A. Enterprise 2 provides the other 50 percent of the equity. Other than the equity and the subordinated loan, no other forms of subordinated financial support exist. Enterprise 2’s interests in A would be outside the scope of the VIE model because it did not provide more than half the subordinated financial support. However, Enterprise 1 must analyze its interest under the VIE model because it provided more than half the total subordinated financial support to the joint venture.
3.4.4.2 Definition of a Business

ASC 805-10-55-3A defines a business as follows:

[A]n integrated set of activities and assets that is capable of being conducted and managed for the purpose of providing a return in the form of dividends, lower costs, or other economic benefits directly to investors or other owners, members, or participants. To be considered a business, an integrated set must meet the requirements in paragraphs 805-10-55-4 through 55-6 and 805-10-55-8 through 55-9.

In January 2017, the FASB issued ASU 2017-01, which narrowed the pool of assets or net assets that are considered a business by providing a “screen” for determining when a set of assets and activities qualifies as a business. The screen ensures that if substantially all of the fair value of the gross assets acquired (or disposed of) is concentrated in a single identifiable asset or group of similar identifiable assets, the set is not a business.

However, a legal entity that gets through the screen (i.e., substantially all of the fair value is not concentrated in a single identifiable asset or group of similar identifiable assets) cannot be considered a business unless it possesses an input and a substantive process that together significantly contribute to the ability to create an output. ASC 805 provides a framework to help entities evaluate whether both an input and a substantive process are present, and it removes the need to assess whether a market participant could potentially replace any missing elements. For further guidance on how to determine whether a legal entity meets the definition of a business, see Deloitte’s A Roadmap to Accounting for Business Combinations.

Note that the business scope exception indicates that even if a potential VIE meets the definition of a business, a reporting entity would analyze its interest in that potential VIE if any of the four conditions in ASC 810-10-15-17(d) are met.

3.4.4.3 [Deleted]

3.4.4.4 When a Reporting Entity Should Assess Whether It Qualifies for the Business Scope Exception

ASC 810-10-15-17(d) states, in part:

A legal entity that previously was not evaluated to determine if it was a VIE because of this provision need not be evaluated in future periods as long as the legal entity continues to meet the conditions in (d).

Each reporting entity should continually evaluate a legal entity to determine whether the reporting entity still qualifies for the business scope exception. A reporting entity should perform this evaluation (1) on the date it becomes involved with the legal entity, (2) when events occur that would require reconsideration under ASC 810-10-35-4 (see Chapter 9) or other events that cause a change in the design of the legal entity occur, and (3) as of each reporting date (see note below). Further, the reassessment of whether a legal entity continues to qualify for the business scope exception is limited to the four conditions specified in ASC 810-10-15-17(d). Therefore, unless a legal entity is fundamentally redesigned and its entire purpose has changed (e.g., all of the operations are spun off and the remaining legal entity represents a single real estate asset), a reporting entity applying the business scope exception is not required to reassess whether the legal entity is a business. If a reporting entity determines that the legal entity qualifies for the business scope exception, the VIE model does not apply and consolidation should be evaluated under the voting interest entity model.

This reassessment could result in a reporting entity's inability to claim the business scope exception in subsequent periods.
Conversely, a reporting entity that has not been able to claim the business scope exception should reassess whether it meets the scope exception only if one of the following types of events occurs:

- Reconsideration events under ASC 810-10-35-4 regarding whether a legal entity is a VIE (see Chapter 9).
- Events that cause a change in the design of the legal entity.

Note that ASC 810-10-15-17(d), read literally, requires a reporting entity to evaluate all the business scope exception factors in each reporting period. The condition in ASC 810-10-15-17(d)(3) indicates that the reporting entity cannot provide more than half the subordinated financial support to the legal entity. However, in performing the ASC 810-10-15-17(d)(3) evaluation, the reporting entity should not conclude that operating losses incurred by the legal entity would, by themselves, cause it to fail to qualify for the scope exception (if it did qualify in previous periods). That is, losses that have reduced the legal entity’s equity such that, on a fair value basis, the reporting entity now provides more than half of the subordinated financial support do not cause a reporting entity to no longer be able to apply the business scope exception. This view is supported by ASC 810-10-35-4, which states, in part:

A legal entity that previously was not subject to the Variable Interest Entities Subsections shall not become subject to them simply because of losses in excess of its expected losses that reduce the equity investment.

[Emphasis added]

**Connecting the Dots**

As discussed in further detail in Section 3.4.4.2, ASU 2017-01 narrowed the definition of a business and consequently reduced the number of legal entities deemed businesses. We do not believe that a reporting entity is generally required upon adoption of ASU 2017-01 to reassess whether a legal entity that previously applied the business scope exception continues to meet the definition of a business. As discussed above, the reassessment of whether a legal entity qualifies for the business scope exception is limited to the four conditions specified in ASC 810-10-15-17(d). Therefore, unless a legal entity is fundamentally redesigned and its entire purpose has changed (e.g., all of the operations are spun off and the remaining legal entity represents a single real estate asset), a reporting entity applying the business scope exception is not required to reassess whether the legal entity is a business.

**Example 3-17**

Enterprise A and Enterprise B, two unrelated parties, form a joint venture, Entity C. The two venturers contribute an equal amount of equity and have joint control of the joint venture. Entity C sells all of its manufactured product to an unrelated third party. At inception, C is determined to be a business under ASC 805 and neither C nor A or B meet any of the four conditions in ASC 810-10-15-17(d). Therefore, both A and B rely on the business scope exception.

Subsequently, C loses its customer and no longer sells to an unrelated third party. Enterprise A enters into a contract to purchase the entire output of the joint venture. Because the new contract results in a change to “the legal entity’s . . . contractual arrangements . . . in a manner that changes the characteristics or adequacy of the legal entity’s equity investment at risk” in accordance with ASC 810-10-35-4(a), the determination of whether A is a VIE should be reconsidered. As a result of the reconsideration, A now meets the condition in ASC 810-10-15-17(d)(2) that the “legal entity is designed so that substantially all of its activities either involve or are conducted on behalf of the reporting entity.” As of the date this condition is met, A must apply the VIE model to C.

Note that because B does not meet any of the conditions in ASC 810-10-15-17(d), it can still rely on the scope exception.
Example 3-18

Assume the same facts as in Example 3-17 before C loses its customer and enters into a purchase contract with A, except that A also loans C an additional amount to fund the venture. The loan has a bullet maturity of 20 years. Because A has provided more than half the total equity and additional subordinated financial support to C via the loan, and there are no other forms of subordinated financial support, A meets the condition in ASC 810-10-15-17(d)(3) and therefore must apply the VIE model to C. Five years after the inception of the entity, C determines that its cash flows have exceeded original expectations and decides to repay A the entire principal on the debt. Early repayment of the debt results in a change to a contractual arrangement that may change the adequacy of C's equity investment at risk (which is a reconsideration event under ASC 810-10-35-4(a)); therefore, A should reassess whether it qualifies for the business scope exception. As of that date, A may qualify for the scope exception because the condition in ASC 810-10-15-17(d)(3) no longer applies — the remaining variable interests are two 50-50 equity interests from A and B. On a fair value basis as of the reconsideration date, the reporting entity (A) is no longer providing more than half the total equity and financial support.

3.4.4.5 Whether the Reporting Entity Participated Significantly in the Design or Redesign of the Legal Entity

A reporting entity must consider all relevant facts and circumstances in determining whether it or its related parties participated significantly in the design or redesign of the legal entity. For this determination, related parties include all parties identified in ASC 810-10-25-43 (see Section 8.2 for a list of related parties and de facto agents) except for the de facto agency relationship that results from Section 8.2.3.4. The following are situations (not all-inclusive) in which the reporting entity would be presumed to have participated significantly in the design or redesign of the legal entity:

- The reporting entity’s interest in the legal entity was obtained at the inception of the legal entity or shortly thereafter. This presumption may be overcome in certain circumstances, such as when the interest is not significant to the legal entity. However, if the lack of participation by a reporting entity would have prevented the creation of the legal entity, that reporting entity always will be deemed to have participated significantly in the design of the legal entity.

- The reporting entity was involved in the execution of the legal entity’s initial or amended governing documents or contractual arrangements (if the amendment to the governing documents or contractual arrangements effectively redesigns the legal entity).

- The legal entity was initially formed, or subsequently restructured, by others on behalf of the reporting entity or its related parties.

- The reporting entity participated significantly (or, via protective or participating rights, had the opportunity to participate regardless of whether these rights were exercised) in significant changes to the legal entity’s operations.

Example 3-19

Entity 1 is a corporation formed with investments by two equity holders and an unrelated debt holder. All of the enterprises were involved in determining the amount of equity and debt financing necessary to fund the entity. The equity holders and the debt holder would be deemed to have participated significantly in the design of Entity 1 because all parties were involved in the legal entity’s design (i.e., establishing the funding requirements of the entity) and in executing the contractual arrangements that established the design.
Example 3-20

Entity 2 is a real estate partnership that entered into a service contract with Enterprise D, a developer, concurrently with Entity 2's formation. The service contract is determined to be a variable interest. According to the terms of the service contract, Enterprise D will construct and manage a majority of Entity 2's assets and has advised Entity 2 about the type of assets to construct for its operations. Because the service contract is negotiated and executed concurrently with the formation of Entity 2 and allows Enterprise D to significantly influence its activities, Enterprise D would be deemed to have participated significantly in the legal entity's design.

3.4.4.6 Definition of a Joint Venture and Joint Control

As noted in ASC 810-10-15-17(d)(1), to qualify for the business scope exception, the reporting entity and its related parties (other than de facto agents under ASC 810-10-25-43(d)) cannot have been involved in the design or redesign of the legal entity unless the legal entity is an operating joint venture under joint control of the reporting entity and one or more independent parties or a franchisee. (See ASC 952-10 for guidance on identifying franchisees.)

ASC 323-10 — Glossary

Corporate Joint Venture

A corporation owned and operated by a small group of entities (the joint venturers) as a separate and specific business or project for the mutual benefit of the members of the group. A government may also be a member of the group. The purpose of a corporate joint venture frequently is to share risks and rewards in developing a new market, product or technology; to combine complementary technological knowledge; or to pool resources in developing production or other facilities. A corporate joint venture also usually provides an arrangement under which each joint venturer may participate, directly or indirectly, in the overall management of the joint venture. Joint venturers thus have an interest or relationship other than as passive investors. An entity that is a subsidiary of one of the joint venturers is not a corporate joint venture. The ownership of a corporate joint venture seldom changes, and its stock is usually not traded publicly. A noncontrolling interest held by public ownership, however, does not preclude a corporation from being a corporate joint venture.

ASC 805-10 — SEC Materials — SEC Staff Guidance

SEC Observer Comment: Accounting by a Joint Venture for Businesses Received at Its Formation

S99-8 The following is the text of SEC Observer Comment: Accounting by a Joint Venture for Businesses Received at Its Formation.

The SEC staff will object to a conclusion that did not result in the application of Topic 805 to transactions in which businesses are contributed to a newly formed, jointly controlled entity if that entity is not a joint venture. The SEC staff also would object to a conclusion that joint control is the only defining characteristic of a joint venture.

ASC 845-10 — SEC Materials — SEC Staff Guidance

SEC Observer Comment: Accounting by a Joint Venture for Businesses Received at Its Formation

S99-2 The following is the text of SEC Observer Comment: Accounting by a Joint Venture for Businesses Received at Its Formation.

The SEC staff will object to a conclusion that did not result in the application of Topic 805 to transactions in which businesses are contributed to a newly formed, jointly controlled entity if that entity is not a joint venture. The SEC staff also would object to a conclusion that joint control is the only defining characteristic of a joint venture.
The ASC master glossary defines a corporate joint venture and provides specific characteristics of a joint venture within that definition. In addition to those characteristics, there is a consensus that venturers must have joint control over an entity for it to be considered a joint venture, as evidenced by the codified comments from the SEC staff observer captured originally in EITF Issue 98-4. Further, the Accounting Standards Executive Committee (AcSEC) indicated in the advisory conclusion of its July 17, 1979, AICPA Issues Paper, “Joint Venture Accounting,” that the element of “joint control” of major decisions should be the central distinguishing characteristic of a joint venture. The AcSEC recommended that the definition in Section 3055 of the Canadian Institute of Chartered Accountants Handbook (subsequently amended) be adopted in substance as the definition of a joint venture. The Handbook defines a joint venture as:

An arrangement whereby two or more parties (the venturers) jointly control a specific business undertaking and contribute resources towards its accomplishment. The life of the joint venture is limited to that of the undertaking which may be of short or long-term duration depending on the circumstances. A distinctive feature of a joint venture is that the relationship between the venturers is governed by an agreement (usually in writing) which establishes joint control. Decisions in all areas essential to the accomplishment of a joint venture require the consent of the venturers, as provided by the agreement; none of the individual venturers is in a position to unilaterally control the venture. This feature of joint control distinguishes investments in joint ventures from investments in other enterprises where control of decisions is related to the proportion of voting interest held.

Although joint control is a joint venture’s most distinguishing feature, it is not the only characteristic of a joint venture, and as indicated in ASC 805-10-S99-8 and ASC 845-10-S99-2, the SEC staff “would object to a conclusion that joint control is the only defining characteristic of a joint venture.”

On the basis of the definition of a joint venture in ASC 323-10-20, we believe that a joint venture has all the following characteristics:

- It is a separate legal entity.
- It is owned by a small group of entities.
- Its operations are for the mutual benefit of the venturers.
- Its purpose is to share risks and rewards in developing a new market, product, or technology; to combine complementary technological knowledge; or to pool resources in developing production or other facilities.
- It allows each venturer to participate, directly or indirectly, in the overall management. The members have an interest or relationship other than that of passive investors.
- It is not a subsidiary of one of the members (commonly referred to as the “joint control” provision).

See Section 7.2 of Deloitte’s A Roadmap to Accounting for Equity Method Investments and Joint Ventures for additional details.

### 3.4.4.7 Whether Substantially All of the Activities Either Involve or Are Conducted on Behalf of the Reporting Entity

A reporting entity should base its determination of whether substantially all of a legal entity’s activities either involve or are conducted on behalf of the reporting entity and its related parties on the design of the legal entity and should compare the nature and extent of the activities between the reporting entity and the legal entity with the entire set of the legal entity’s activities. For this determination, related parties include all parties identified in ASC 810-10-25-43 except for de facto agents as described in ASC 810-10-25-43(d). Generally, if 90 percent or more of the legal entity’s activities are conducted on behalf

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3 The requirement that all the conditions must be met is consistent with the views expressed by SEC Professional Accounting Fellow Chris Rogers at the 2014 AICPA Conference on Current SEC and PCAOB Developments. Deloitte’s A Roadmap to Accounting for Equity Method Investments and Joint Ventures provides more information.
of a reporting entity and its related parties, it is presumed to be “substantially all” of the legal entity's activities. However, less than 90 percent is not a safe harbor. The evaluation should not necessarily be based on the reporting entity's economic interest(s) in a legal entity. However, significant economic interests in a legal entity may indicate that substantially all of the legal entity's activities either involve, or are conducted on behalf of, the reporting entity and its related parties.

The following conditions may indicate (depending on their relative significance) that substantially all of a legal entity's activities are conducted on behalf of a reporting entity and its related parties:

- The reporting entity has entered into an agreement to purchase the output of the legal entity.
- The legal entity purchases the inputs for its products, services, or both from the reporting entity, and the activities of the legal entity are an extension of the reporting entity's activities.
- The legal entity acts as a reseller of the reporting entity's finished products or services.
- The legal entity was designed or redesigned to provide goods, services, or both exclusively to the reporting entity's customers.
- The legal entity's assets are leased to or from the reporting entity.
- The legal entity depends on the reporting entity when conducting its ongoing business activities (without a similar level of dependency on other parties).
- The legal entity enters into an outsourcing or tolling arrangement in which the reporting entity agrees to (1) provide raw materials, other inputs, or both and (2) purchase all of the related finished product from the legal entity.
- The legal entity enters into a technical service agreement in which the reporting entity provides the legal entity with a variety of technical, consulting, and administrative services.
- The legal entity is dedicated to developing pharmaceutical, biotech, software, or other in-process technology, and the reporting entity has rights to the resulting product.
- The reporting entity holds options or other securities to acquire the other investors' interests in the legal entity.
- The other investors in the legal entity hold options or other securities that allow them to put their interests to the reporting entity.
- The reporting entity is obligated to provide additional funding when operating losses occur, current funding is insufficient, or both.
- The economics of the legal entity are designed or redesigned to be heavily weighted toward the reporting entity.
- The reporting entity's employees act as management for the legal entity.
- The legal entity's employees receive incentive compensation that depends on the financial results of the reporting entity.

Note that these conditions are also important to the determination of whether a legal entity is a VIE under ASC 810-10-15-14(c). See Section 5.4.2 for additional examples.
Example 3-21

Enterprise A owns an equity interest in Entity B, a public utility company that meets the definition of a business in ASC 805. Entity B provides electricity to unrelated third parties. There are no other interests or agreements between A and B. Because B conducts activities (i.e., producing electricity) on behalf of third-party customers, it does not conduct its activities on behalf of A. Therefore, substantially all of B's activities neither involve nor are conducted on behalf of A. However, A would still need to determine whether the other conditions in ASC 810-10-15-17(d) are met.

Conversely, assume that A enters into a long-term power purchase agreement (PPA) for 100 percent of B's output. In this case, A would not be able to apply the business scope exception because substantially all of B's activities are conducted on A's behalf.

Example 3-22

Entity G is created solely to lease diagnostic equipment to hospitals. Enterprise H owns several hospitals and enters into an agreement to exclusively lease its diagnostic equipment from G. This arrangement represents 40 percent of G's total leasing activities. Assume that there are no other arrangements between G and H and that G is a business as defined in ASC 805.

Although H leases 100 percent of its diagnostic equipment from G, the exclusive leasing arrangement does not, in itself, represent substantially all of G's activities because G conducts the remaining 60 percent of its leasing activities with unrelated parties. However, H would still need to determine whether the other conditions in ASC 810-10-15-17(d) are met.

Example 3-23

A joint venture entity (Entity C) is formed by two unrelated parties, Enterprises A and B. Each investor has a 50 percent equity interest. Entity C's activities consist solely of purchasing a product from A and selling and distributing it to third-party customers.

Because of its current design, C represents another distribution or sales channel for A's merchandise. Entity C appears to be an extension of A's business because it is so closely aligned in appearance and purpose. Therefore, substantially all of C's activities either involve or are conducted on A's behalf and, accordingly, the business scope exception cannot be applied by A.

Example 3-24

A joint venture entity (Entity C) is formed by two unrelated parties, Enterprises A and B. Each investor has a 50 percent equity interest in C. Entity C has contracted to purchase all of its raw materials from A. Entity C uses these raw materials to manufacture finished goods to sell to third-party customers.

In this example (unlike Example 3-23), C does not appear to be an extension of A's business. Even though A provides all of C's raw materials, C uses those raw materials to manufacture finished goods as opposed to just selling, without modifying, the raw materials purchased from A. Thus, C has not been designed so that substantially all of its activities either involve or are conducted on A's behalf. However, A would still need to determine whether the other conditions in ASC 810-10-15-17(d) are met.

Example 3-25

An investment hedge fund is established by a 99 percent limited partner and a 1 percent general partner. The fund has no other activities, and profits and losses are allocated according to ownership interests. In this scenario, the only activity of the fund is to invest its money and to provide returns to the general partner and limited partner. As currently designed, the fund's activities, as well as its economics, are heavily weighted toward the limited partner. Therefore, substantially all of the fund's activities involve or are conducted on behalf of the limited partner and, accordingly, the business scope exception cannot be applied by the limited partner.
3.4.4.8 Whether a Financing Represents Subordinated Financial Support

In general, all forms of financing are “subordinated financial support” unless the financing is the most senior class of liabilities and is considered “investment-grade.” Standard & Poor’s and Moody’s categorize investment-grade debt as that rated BBB or higher and Baa or higher, respectively. If the debt is not rated, it should be considered investment-grade only if it possesses characteristics that warrant such a rating. Evaluating whether a nonrated instrument possesses the same characteristics to be considered investment-grade requires careful consideration.

ASC 810-10-20 defines subordinated financial support as variable interests that will absorb some or all of a legal entity’s expected losses (see also Section 2.13). The determination that non-investment-grade debt is subordinated is based on the view that the debt holder is exposed to a more than remote chance of experiencing a credit loss. Therefore, unless the financing is investment-grade or, if the debt is not rated, possesses the same characteristics as investment-grade debt, the financing should be considered subordinated. This conclusion is consistent with ASC 810-10-55-23, which states, in part, that the “return to the most subordinated interest usually is a high rate of return (in relation to the interest rate of an instrument with similar terms that would be considered to be investment grade)” (emphasis added).

Example 3-26

Two unrelated parties, Enterprise A and Enterprise B, form a joint venture, Entity C, that meets the definition of a business in ASC 805. Enterprises A and B each contribute equity with a fair value of $20 and share equally in all voting matters. In addition, A lends $10 to C. The fair value of the loan is $10 and it is not considered investment-grade. Enterprise A has provided subordinated financial support with a fair value of $30 ($20 in equity and $10 in debt), which is more than half the total subordinated financial support of C ($50). Therefore, A cannot apply the business scope exception. However, if none of the other conditions in ASC 810-10-15-17(d) are met, B should apply the business scope exception because it does not provide more than half of the subordinated financial support.

3.4.4.9 Whether More Than Half of the Total of Equity, Debt, and Other Subordinated Financial Support Has Been Provided by the Reporting Entity and Its Related Parties

Under ASC 810-10-15-17(d)(3), a reporting entity must identify all forms of subordinated financial support that it or its related parties have provided to the legal entity. Related parties would include all parties identified in ASC 810-10-25-43 except for the de facto agency relationship that results from the transfer restrictions described in Section 8.2.3.4. (See Section 3.4.4.8 above for a discussion of how to determine whether the financing is subordinated.)

In determining whether the reporting entity or its related parties have provided more than half of the equity, debt, and other forms of subordinated financial support to a legal entity, the reporting entity should aggregate the fair value of the total equity, subordinated debt, and other forms of subordinated financial support that it (and its related parties) provides to the legal entity. If that amount is greater than half the fair value of the total equity, subordinated debt, and other forms of subordinated financial support of the legal entity, the reporting entity would meet this condition and therefore should not be able to apply the business scope exception.

A reporting entity must consider whether any variable interests that it (or its related parties) holds (in addition to equity or subordinated debt) constitute additional subordinated financial support. Many of the examples of variable interests cited in Table 4-1 in Section 4.3 (such as certain guarantees, put options, and agreements to provide services to the legal entity) will be considered a form of...
subordinated financial support if there is more than a remote chance that they absorb some or all of the expected losses of a legal entity.

<table>
<thead>
<tr>
<th>Example 3-27</th>
</tr>
</thead>
<tbody>
<tr>
<td>Company A contributes $5 million cash, and a guarantee of debt with a fair value of $1 million, in exchange for 67 percent of the equity of Entity X. Other equity holders contribute $3 million in cash to the entity in exchange for the remaining 33 percent of the equity in X, and X raises additional funds via a $2 million note payable (guaranteed by A) to a financial institution that is considered additional subordinated financial support. The guarantee absorbs expected losses of the entity and is therefore also considered to be additional subordinated financial support. Since the aggregate fair value of A’s equity and the guarantee ($6 million) is more than half of the total equity, debt, and other forms of subordinated financial support of X, A would not be able to avail itself of the business scope exception.</td>
</tr>
</tbody>
</table>

### 3.4.4.10 Additional Subordinated Financial Support — Put and Call Options

A put or call option between equity owners in a legal entity (e.g., between joint venture partners) can have an impact on whether a reporting entity meets the condition in ASC 810-10-15-17(d)(3) and, therefore, on whether it can apply the business scope exception. The examples below illustrate situations in which (1) a put option (purchased by one investor from the reporting entity) results in the reporting entity’s ineligibility for the business scope exception since the reporting entity effectively provides more than half of the total equity, subordinated debt, and other forms of subordinated financial support to the legal entity and (2) a call option would not have the same impact.

<table>
<thead>
<tr>
<th>Example 3-28</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Put Options</strong></td>
</tr>
<tr>
<td>Investor A and Investor B form Entity X with equal contributions of equity. Investor B purchases a put option from A that permits it to put its interest in X to A at a fixed price.</td>
</tr>
</tbody>
</table>

The fair value of the fixed-price put option should be considered additional subordinated financial support provided by A to X because A will absorb expected losses of X upon exercise of that put option (i.e., it meets the definition of subordinated financial support in ASC 810-10-20). Therefore, A would consider the fair value of the fixed-price put option (presumably the price paid) in determining whether the condition in ASC 810-10-15-17(d)(3) is met. If the fair value of the put option is greater than zero, A would meet this condition and therefore would not be able to use the business scope exception since the fair value of the equity provided by A and the fair value of the put option written by A would constitute more than half the total of the equity, subordinated debt, and other forms of subordinated financial support to the legal entity.
Example 3-29

Call Option

Investor A and Investor B form Entity X with equal contributions of equity. Investor A purchases a call option from B that permits it to call B’s interest at a fixed price (the call option’s strike price is at or above the fair value of the equity interest at inception of the option).

The fair value of the fixed-price call option should not be considered additional subordinated financial support to X because A will not absorb expected losses of X upon exercise of that call option (i.e., the option does not meet the definition of subordinated financial support in ASC 810-10-20). Investor A can exercise its call and obtain additional residual returns of X, but the call option does not expose it to additional expected losses. Therefore, A would not consider the fair value of the fixed-price call option in determining whether it meets the condition in ASC 810-10-15-17(d)(3). Investors A and B would not meet this condition since the fair value of the equity provided by each investor would not constitute more than half of the total of the equity, subordinated debt, and other forms of subordinated financial support to the legal entity. To use the business scope exception, A and B must determine whether the other conditions in ASC 810-10-15-17(d) are met.

3.4.4.11 Single-Lessee Leasing Activities

The business scope exception in ASC 810-10-15-17(d) may not be applied to legal entities whose activities are primarily related to single-lessee leasing arrangements, regardless of whether the leasing arrangements are accounted for as operating leases or capital leases. Lessee reporting entities sometimes question whether it is necessary to evaluate the potential consolidation of a lessor entity that holds a single asset that it leases to the lessee reporting entity that is accounted for as a capital lease (i.e., the lessee reporting entity has already recorded the leased asset on its balance sheet). While the accounting treatment of a capital or finance lease under ASC 840 or ASC 842, respectively, may be similar to the consolidation of the asset and related debt obligation, the accounting result may be different (see Section 4.3.9.2) and therefore a lessee must evaluate its interest in the lessor for consolidation unless it qualifies for a scope exception.

Whether a legal entity is considered a single-lessee leasing arrangement depends on whether the primary activity of the legal entity is leasing (as lessor) to a single lessee. This evaluation is based on various qualitative and quantitative factors, including why the legal entity was created, the terms of the lease contracts the legal entity has entered into, the significance of the legal entity’s cash flows derived from leasing activities compared with its other activities, and the significance of the assets being leased compared with the legal entity’s other assets.

For legal entities whose primary activity is leasing, the next step is to determine whether the assets or group of assets is being leased by a single lessee. In making this determination, a reporting entity should look to the substance of the arrangement. For example, although governing documents may permit the leasing of assets of the legal entity to more than one party, the reporting entity should consider the intent of the legal entity and the actual leasing arrangements. The leasing of assets to multiple parties

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4 Notwithstanding the FASB’s issuance of ASU 2016-02 (codified in ASC 842), which replaced the term “capital lease” with “finance lease” in GAAP, a reporting entity would apply this guidance to its finance leases upon adopting ASC 842 in the same manner it applied it to its capital leases before adopting ASC 842.
that are all part of a related-party group would generally be equivalent to leasing assets to a single lessee.

**Example 3-30**

Entity A is designed to own and lease retail buildings as well as an office park with multiple office buildings to various commercial and noncommercial tenants, and it meets the definition of a business in ASC 805. About 60 percent of A’s leasing activities are conducted with Enterprise B, an equity investor that leases office buildings; the remaining 40 percent of the leasing activities are conducted with unrelated third-party customers. There are no other arrangements between B and A. In this example, although A’s primary activity is leasing, A was designed to lease its properties (and is actually leasing its properties) to B as well as to unrelated third-party customers. Therefore, A would not meet the condition in ASC 810-10-15-17(d)(4) and should apply the business scope exception if none of the other conditions in ASC 810-10-15-17(d) are met.

**Example 3-31**

Assume the same facts as in Example 3-30 except that A does not have any leasing activity with unrelated third-party customers and B leases 100 percent of A’s properties (the retail buildings and all office park buildings). In this example, A meets the condition in ASC 810-10-15-17(d)(4), and B cannot apply the business scope exception because this transaction is considered a single-lessee leasing arrangement.

**Example 3-32**

Entity A (a business) leases construction equipment to unrelated third parties, which represents 30 percent of A’s cash flows. Entity A’s remaining business activities do not involve leasing, securitizations, or asset-backed financings. Enterprise B enters into a contract in which it will lease several pieces of construction equipment from A. Once executed, the lease contract will represent all the cash flows from A’s leasing business. There are no other arrangements between A and B.

Although the cash flows from the lease contract represent all of A’s leasing business, A was not specifically designed to enter into single-lessee leasing arrangements. In addition, A’s activities are not primarily related to either leasing or asset-backed financings, as demonstrated by its significant business activities with parties other than B. Therefore, A does not meet the condition in ASC 810-10-15-17(d)(4), and B should apply the business scope exception if none of the other conditions in ASC 810-10-15-17(d) are met.

**Example 3-33**

Entity A owns 10 office buildings and 10 parking garages. It leases each of these buildings and parking garages to a different enterprise that is either partially or wholly owned by the same parent, Enterprise X. Entity A meets the definition of a business in ASC 805. Further, A’s governing documents do not restrict it from entering into lease contracts with parties other than X and its related-party group, nor was A designed solely to lease its properties to X. However, even though A’s governing documents allow it to enter into lease contracts with parties other than X and its related-party group, the actual activities of A involve leasing the office buildings and parking garages to a single related-party group. The individual lease contracts should therefore be viewed as a single-lessee leasing arrangement. Consequently, X cannot apply the business scope exception to A because the condition in ASC 810-10-15-17(d)(4) is met.

### 3.5 Private-Company Alternative

In March 2014, the FASB issued ASU 2014-07 in response to a consensus reached by the Private Company Council (PCC). The ASU offers an accounting alternative to the VIE model for private-company lessees that enter into a lease arrangement with a lessor entity under common control. It does not apply to public business entities, NFPs, or employee benefit plans within the scope of ASC 960 or ASC 965.
In October 2018, the FASB issued ASU 2018-17, which broadens the existing accounting alternative available to private companies under ASU 2014-07 by allowing all legal entities under common control to elect not to apply the VIE guidance as long as certain criteria are met.

### 3.5.1 Before the Adoption of ASU 2018-17

<table>
<thead>
<tr>
<th>ASC 810-10</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>15-17AB</strong> A legal entity need not be evaluated by a private company under the guidance in the Variable Interest Entities Subsections if criteria (a) through (c) are met and, in applicable circumstances, criterion (d) is met:</td>
</tr>
<tr>
<td>a. The private company lessee (the reporting entity) and the lessor legal entity are under common control.</td>
</tr>
<tr>
<td>b. The private company lessee has a lease arrangement with the lessor legal entity.</td>
</tr>
<tr>
<td>c. Substantially all activities between the private company lessee and the lessor legal entity are related to leasing activities (including supporting leasing activities) between those two entities.</td>
</tr>
<tr>
<td>d. If the private company lessee explicitly guarantees or provides collateral for any obligation of the lessor legal entity related to the asset leased by the private company, then the principal amount of the obligation at inception of such guarantee or collateral arrangement does not exceed the value of the asset leased by the private company from the lessor legal entity.</td>
</tr>
</tbody>
</table>

See paragraph 810-10-55-9 and paragraphs 810-10-55-205AJ through 55-205AR for implementation guidance.

| **15-17B** Application of this accounting alternative is an accounting policy election that shall be applied by a private company to all legal entities, provided that all of the criteria for applying this accounting alternative specified in paragraph 810-10-15-17AB are met. For lessor legal entities that as a result of this accounting alternative are excluded from applying the guidance in the Variable Interest Entities Subsections, a private company lessee shall continue to apply other accounting guidance (including guidance in the General Subsections of this Subtopic and guidance included in Subtopic 810-20 on control of partnerships and similar entities) as applicable. A private company that elects this accounting alternative shall disclose the required information specified in paragraph 810-10-50-2AD unless the lessor legal entity is consolidated through accounting guidance other than VIE guidance. |

| **15-17C** If any of the conditions in paragraph 810-10-15-17AB for applying the accounting alternative cease to be met, a private company shall apply the guidance in the Variable Interest Entities Subsections at the date of change on a prospective basis. |

As stated in the guidance above, the existing accounting alternative allows a private-company lessee (reporting entity) to elect not to apply the VIE model to a lessor entity if:

- “The private company lessee (the reporting entity) and the lessor legal entity are under common control.”
- “The private company lessee has a lease arrangement with the lessor legal entity.”
- “Substantially all activities between the private company lessee and the lessor legal entity are related to leasing activities (including supporting leasing activities) between those two entities.”
- The “private company lessee explicitly guarantees or provides collateral for any obligation of the lessor legal entity related to the asset leased by the private company.” In such a case, “the principal amount of the obligation at inception of such guarantee or collateral arrangement does not exceed the value of the asset leased by the private company from the lessor legal entity.”

The accounting alternative is an accounting policy election. Once elected, the alternative must be applied by the private-company lessee to all current and future lessor entities under common control that meet the application criteria. Private companies that elect this alternative would apply the voting interest
entity model as well as other applicable guidance, including ASC 840 or ASC 842 on leases. ASC 810-10-55-205A through 55-205AR provide implementation examples that illustrate the evaluation of whether a private-company lessee qualifies for this accounting alternative.

Further, private companies that elect the alternative are required to disclose the information specified in ASC 810-10-50-2AD unless accounting guidance other than VIE guidance is applied to consolidate the lessor legal entity. See Section 11.2.5.3 for additional discussion of the disclosure requirements.

Changing Lanes
In October 2018, the FASB issued ASU 2018-17, which, in part, expands the private-company scope exception to the VIE guidance for entities under common control. See Section 3.5.2 below for discussion of the private-company scope exception. For more information about ASU 2018-17, see Deloitte's November 19, 2018, Heads Up.

3.5.2 After the Adoption of ASU 2018-17

ASC 810-10

<table>
<thead>
<tr>
<th>Pending Content (Transition Guidance: ASC 810-10-65-9)</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>15-17AD</strong> A legal entity need not be evaluated by a private company (reporting entity) under the guidance in the Variable Interest Entities Subsections if all of the following criteria are met:</td>
</tr>
<tr>
<td>a. The reporting entity and the legal entity are under common control.</td>
</tr>
<tr>
<td>b. The reporting entity and the legal entity are not under common control of a public business entity.</td>
</tr>
<tr>
<td>c. The legal entity under common control is not a public business entity.</td>
</tr>
<tr>
<td>d. The reporting entity does not directly or indirectly have a controlling financial interest in the legal entity when considering the General Subsections of this Topic. The Variable Interest Entities Subsections shall not be applied when making this determination.</td>
</tr>
</tbody>
</table>

Applying this accounting alternative is an accounting policy election. If a private company elects to apply this accounting alternative, it shall apply this alternative to all legal entities if criteria (a) through (d) are met. A reporting entity that elects the accounting alternative and, thus, does not apply the guidance in the Variable Interest Entities Subsections shall continue to apply other accounting guidance (including guidance in the General Subsections of this Subtopic) unless another scope exception from this Topic applies. A reporting entity applying this alternative shall disclose the required information specified in paragraphs 810-10-50-2AG through 50-2AI unless the legal entity is consolidated by the reporting entity through accounting guidance other than VIE guidance.

| **15-17AE** To determine whether the private company (reporting entity) and the legal entity are under common control of a parent solely for the purpose of applying paragraph 810-10-15-17AD(a), the private company shall consider only the parent's direct and indirect voting interest in the private company and the legal entity. In other words, only the guidance in the General Subsections of this Topic shall be considered for determining whether a parent has a direct or indirect controlling financial interest in the private company and the legal entity as required in paragraph 810-10-15-17AD(a). The guidance in the Variable Interest Entities Subsections of this Topic shall not be applied for making this determination. See paragraphs 810-10-55-205AU through 55-205AZ for illustrative guidance. |

| **15-17AF** If any of the criteria in paragraph 810-10-15-17AD for applying the accounting alternative cease to be met, a private company shall apply the guidance in the Variable Interest Entities Subsections at the date of change on a prospective basis, except for situations in which a reporting entity becomes a public business entity. When a reporting entity becomes a public business entity, it shall apply the guidance in the Variable Interest Entities Subsections in accordance with Topic 250 on accounting changes and error corrections. |
ASU 2018-17 broadens the existing accounting alternative available to private companies by allowing all legal entities under common control to elect not to apply the VIE guidance as long as the reporting entity, the common-control parent, and the legal entity being evaluated for consolidation are not public business entities and meet the criteria in ASC 810-10-15-17AD. ASU 2018-17 allows a private company (reporting entity) not to apply the VIE model if:

- “The reporting entity and the legal entity are under common control.”
- “The reporting entity and the legal entity are not under common control of a public business entity.”
- “The legal entity under common control is not a public business entity.”
- “The reporting entity does not directly or indirectly have a controlling financial interest in the legal entity when considering the General Subsections of [ASC 810]. The Variable Interest Entities Subsections shall not be applied when making this determination.”

ASC 810-10-15-17AE provides guidance on applying the first criterion above, which requires a determination that the reporting entity and the legal entity are under common control. Specifically, ASC 810-10-15-17AE states that solely in the application of the first criterion, a private-company reporting entity should consider only the voting interest entity model when making this determination. That is, a private-company reporting entity should not consider the VIE guidance when determining whether the first criterion of ASC 810-10-15-17AD is met.

The example below illustrates the application of ASC 810-10-15-17AD.

**Example 3-34**

Parent has a 100 percent direct voting interest in Entity A (the reporting entity) and a 70 percent direct voting interest in Entity B. Entity A has a 30 percent direct voting interest in B and a 60 percent direct voting interest in C. Third-Party Investor has a 40 percent direct voting interest in C.

The respective voting interest of Parent, A, and Third-Party Investor are summarized in the diagram below.
Further assume the following:

- None of the entities are public business entities; therefore, criteria (b) and (c) in ASC 810-10-15-17AD are met.
- There are no contractual arrangements through which a third party controls B or C.
- Third-Party Investor does not have substantive participating rights in C.

Parent has a controlling financial interest in A, B, and C through its direct and indirect voting interests. Therefore, A, B, and C are under common control with respect to criterion (a) in ASC 810-10-15-17AD.

Entity A can apply the private-company scope exception of ASC 810-10-15-17AD to B because A does not directly or indirectly have a controlling financial interest in B and therefore also meets criterion (d). However, A cannot apply the scope exception to C because A has a controlling financial interest in C and therefore does not meet criterion (d).

ASU 2018-17 supersedes the existing accounting alternative under ASC 810 that originated from ASU 2014-07 because the FASB believes that the new guidance on common-control relationships for private companies would encompass existing leasing arrangements that qualified for the previous scope exception. Like the accounting alternative under current guidance, the private-company scope exception provided by ASU 2018-17 would be considered an accounting policy that, if elected, should be applied consistently to all legal entities that qualify for it. The exception is effective for private companies for fiscal years beginning after December 15, 2020, and interim periods within fiscal years beginning after December 15, 2021. Early adoption is permitted.

Because the scope exception is limited to the VIE guidance, private-company reporting entities will continue to be required to evaluate the consolidation guidance under the voting interest entity model to determine whether they have a controlling financial interest. Such entities that apply the scope exception but do not have a controlling financial interest under the voting interest entity model will be required to provide enhanced disclosures (see ASC 810-10-50-2AG through 50-2AI) that are similar to those required of entities that apply the VIE guidance. See Section 11.2.5.3 for a discussion of the required disclosures.

Connecting the Dots

Common-Control Considerations

Application of Common-Control Under ASU 2018-17 as Compared With ASU 2014-07

As noted above, ASU 2018-17 permits a reporting entity to apply the new private-company scope exception only if the reporting entity and legal entity are under common control on the basis of a common-control parent’s voting interest. Since ASU 2014-07 did not define common control or limit how to determine whether entities that intend to apply the scope exception in that ASU are under common control, it is possible that a reporting entity that currently applies ASU 2014-07 would not meet the criteria to apply the scope exception in ASU 2018-17. In the illustration below, we would not expect Subsidiary A (the reporting entity) to be eligible to apply the scope exception in ASU 2018-17, because Parent is the primary beneficiary of Subsidiary A through a contractual arrangement and does not hold any voting interest in Subsidiary A. Therefore, Subsidiary A (the reporting entity) and Subsidiary B (the legal entity) are not under common control of Parent solely on the basis of voting interest.
Applicability of the Private-Company Scope Exception to Parent-Subsidiary Relationships

In paragraph BC69 of ASU 2015-02, the FASB explains that in accordance with the VIE model, entities under common control include “subsidiaries controlled (directly or indirectly) by a common parent, or a subsidiary and its parent.”

Although paragraph BC69 of ASU 2015-02 highlights that a parent and its subsidiary are entities under common control, we do not believe that the private-company scope exception in ASU 2018-17 can be applied to parent-subsidiary common-control relationships when the parent is the reporting entity. To be under common control for the application of criterion (a) in ASC 810-10-15-17AD, a parent must have a controlling financial interest through its voting interest in both the reporting entity and the legal entity. If the parent is also the reporting entity, criterion (d) in ASC 810-10-15-17AD is not met because the reporting entity (in this case, the parent) has a controlling financial interest in the legal entity through its voting interest.

Effective Date and Transition

In March 2016, the FASB issued ASU 2016-03, which gives private companies a one-time unconditional option to forgo a preferability assessment the first time they elect a private-company accounting alternative within the ASU’s scope. ASU 2016-03 contains no effective date or transition guidance, eliminates the effective dates of private-company accounting alternatives that are within the ASU’s scope, and extends the transition guidance for such alternatives indefinitely.

By contrast, ASU 2018-17 includes an effective date and transition guidance for applying the new private-company scope exception and other guidance in the ASU. During deliberations of the ASU, the FASB discussed whether the effective date and transition guidance in ASU 2018-17 should be aligned with ASU 2016-03; however, the Board decided that such alignment would be burdensome for reporting entities that currently apply the existing accounting alternative under ASC 810 because they would have to apply the new private-company scope exception immediately to maintain their existing accounting presentation and, consequently, apply the exception to all other legal entities that are eligible for it at that time. Accordingly, the December 15, 2020, effective date of ASU 2018-17 for private companies is intended to give those companies sufficient time to decide whether they want to elect the new private-company scope exception. However, a reporting entity will be required to perform a preferability assessment in accordance with ASC 250 if it elects the exception after the effective date of ASU 2018-17 and the election represents a change in accounting policy.
Chapter 4 — Variable Interests

4.1 Introduction

One of the first steps in assessing whether a reporting entity is required to consolidate another legal entity is to determine whether the reporting entity holds a variable interest in the legal entity being evaluated for consolidation. This determination is important for several reasons, including the following:

- If a reporting entity determines that it does not have a variable interest in the legal entity, no further analysis is required. That is, that reporting entity is not required to consolidate the legal entity or provide any of the VIE disclosures related to the legal entity.
- The identification of the variable interests may affect whether the legal entity is a VIE (see Chapter 5).
- The evaluation of whether the reporting entity has a variable interest in a legal entity may affect its assessment of whether it has an obligation to absorb losses or the right to receive benefits of the VIE that could potentially be significant to the VIE in the primary-beneficiary analysis (see Chapter 7).
- A reporting entity that has a variable interest in a VIE may be required to provide certain disclosures (see Section 11.2).

While there are many forms of variable interests, all variable interests will absorb portions of a VIE’s variability (changes in the fair value of the VIE’s net assets exclusive of variable interests) that the legal entity was designed to create. An interest that creates variability would not be considered a variable interest.
It is often simple to identify whether a contract or arrangement is a variable interest. A good rule of thumb is that most arrangements on the credit side of the balance sheet (e.g., equity and debt) are variable interests because they absorb variability as a result of the performance of the legal entity. However, identifying whether other arrangements (e.g., derivatives, leases, and decision-maker and other service-provider contracts) are variable interests can be more complex. See Section 4.4 for a discussion of decision-maker and service-provider fees and the criteria for assessing whether such fees represent variable interests and should therefore be evaluated further in the consolidation flowchart.

As discussed in more detail in Section 4.2, the FASB established a two-step “by-design” approach for the identification of variable interests. Under this approach the reporting entity would (1) “analyze the nature of the risks in the legal entity” and (2) “determine the purpose(s) for which the legal entity was created and determine the variability (created by the risks identified in Step 1) the legal entity is designed to create and pass along to its interest holders.” The by-design principle is relevant because while a contract or arrangement may absorb certain variability from a legal entity, the contract or arrangement would generally not be a variable interest if the variability absorbed is related to a risk the legal entity was not “designed” to pass on to the interest holder.

4.2 The By-Design Approach to Determining Variability

ASC 810-10

25-22 The variability to be considered in applying the Variable Interest Entities Subsections shall be based on an analysis of the design of the legal entity as outlined in the following steps:

a. Step 1: Analyze the nature of the risks in the legal entity (see paragraphs 810-10-25-24 through 25-25).

b. Step 2: Determine the purpose(s) for which the legal entity was created and determine the variability (created by the risks identified in Step 1) the legal entity is designed to create and pass along to its interest holders (see paragraphs 810-10-25-26 through 25-36).

25-23 For purposes of paragraphs 810-10-25-21 through 25-36, interest holders include all potential variable interest holders (including contractual, ownership, or other pecuniary interests in the legal entity). After determining the variability to consider, the reporting entity can determine which interests are designed to absorb that variability. The cash flow and fair value are methods that can be used to measure the amount of variability (that is, expected losses and expected residual returns) of a legal entity. However, a method that is used to measure the amount of variability does not provide an appropriate basis for determining which variability should be considered in applying the Variable Interest Entities Subsections.

25-24 The risks to be considered in Step 1 that cause variability include, but are not limited to, the following:

a. Credit risk
b. Interest rate risk (including prepayment risk)
c. Foreign currency exchange risk
d. Commodity price risk
e. Equity price risk
f. Operations risk.

25-25 In determining the purpose for which the legal entity was created and the variability the legal entity was designed to create and pass along to its interest holders in Step 2, all relevant facts and circumstances shall be considered, including, but not limited to, the following factors:

a. The activities of the legal entity
b. The terms of the contracts the legal entity has entered into
c. The nature of the legal entity's interests issued
d. How the legal entity's interests were negotiated with or marketed to potential investors
e. Which parties participated significantly in the design or redesign of the legal entity.
ASC 810-10 (continued)

25-26 Typically, assets and operations of the legal entity create the legal entity’s variability (and thus, are not variable interests), and liabilities and equity interests absorb that variability (and thus, are variable interests). Other contracts or arrangements may appear to both create and absorb variability because at times they may represent assets of the legal entity and at other times liabilities (either recorded or unrecorded). The role of a contract or arrangement in the design of the legal entity, regardless of its legal form or accounting classification, shall dictate whether that interest should be treated as creating variability for the entity or absorbing variability.

25-27 A review of the terms of the contracts that the legal entity has entered into shall include an analysis of the original formation documents, governing documents, marketing materials, and other contractual arrangements entered into by the legal entity and provided to potential investors or other parties associated with the legal entity.

25-28 Example 3 (see paragraph 810-10-55-55) is intended to demonstrate how to apply the provisions of this guidance on determining the variability to be considered, including whether arrangements (such as derivative instruments or guarantees of value) create variability (and are therefore not variable interests) or absorb variability (and are therefore variable interests).

25-29 A qualitative analysis of the design of the legal entity, as performed in accordance with the guidance in the Variable Interest Entities Subsections, will often be conclusive in determining the variability to consider in applying the guidance in the Variable Interest Entities Subsections, determining which interests are variable interests, and ultimately determining which variable interest holder, if any, is the primary beneficiary.

25-30 The following addresses various considerations related to determination of variability, specifically:
   a. Terms of interests issued
   b. Subordination
   c. Certain interest rate risk
   d. Certain derivative instruments.

Terms of Interests Issued

25-31 An analysis of the nature of the legal entity's interests issued shall include consideration as to whether the terms of those interests, regardless of their legal form or accounting designation, transfer all or a portion of the risk or return (or both) of certain assets or operations of the legal entity to holders of those interests. The variability that is transferred to those interest holders strongly indicates a variability that the legal entity is designed to create and pass along to its interest holders.

Subordination

25-32 For legal entities that issue both senior interests and subordinated interests, the determination of which variability shall be considered often will be affected by whether the subordination (that is, the priority on claims to the legal entity’s cash flows) is substantive. The subordinated interest(s) (as discussed in paragraph 810-10-55-23) generally will absorb expected losses prior to the senior interest(s). As a consequence, the senior interest generally has a higher credit rating and lower interest rate compared with the subordinated interest. The amount of a subordinated interest in relation to the overall expected losses and residual returns of the legal entity often is the primary factor in determining whether such subordination is substantive. The variability that is absorbed by an interest that is substantively subordinated strongly indicates a particular variability that the legal entity was designed to create and pass along to its interest holders. If the subordinated interest is considered equity-at-risk, as that term is used in paragraph 810-10-15-14, that equity can be considered substantive for the purpose of determining the variability to be considered, even if it is not deemed sufficient under paragraphs 810-10-15-14(a) and 810-10-25-45.
4.2.1 **Steps of the By-Design Approach**

The by-design approach in ASC 810-10-25-22 requires a reporting entity to determine which variability to consider in evaluating whether an interest is a variable interest on the basis of the design and purpose of the legal entity. The reporting entity analyzes the legal entity to determine (1) its design, including the nature of the risks in the legal entity, and (2) why the legal entity was created and the variability that the legal entity is designed to create and pass along to its interest holders. In performing this analysis, the reporting entity should review in detail the terms of the contracts that the legal entity has entered into and provided to potential investors or other parties associated with the entity, including the original formation documents, governing documents, marketing materials, and other contractual arrangements. ASC 810-10-55-55 through 55-86 provide additional guidance, including indicators and examples, to help reporting entities apply this approach.

Under the by-design approach, the following two-step analysis is used in the evaluation of which variability to consider in the determination of whether an interest is a variable interest:

- **Step 1** — “Analyze the nature of the risks in the legal entity.”
- **Step 2** — “Determine the purpose(s) for which the legal entity was created and determine the variability (created by the risks identified in Step 1) the legal entity is designed to create and pass along to its interest holders.”

4.2.1.1 **Performing Step 1**

4.2.1.1.1 **Types of Risks**

Examples of risks that may cause variability include, but are not limited to, credit risk, interest rate risk (including prepayment risk), foreign currency exchange risk, commodity price risk, equity price risk, and operations risk. Although all risks should be considered in step 1, they should not all be included in the identification of variable interests. For example, a legal entity that has foreign currency risk or interest rate risk may not have been designed to pass on those risks. This might be the case if the legal entity invests excess cash in variable-rate debt securities; however, by design, its primary activities do not include investing in debt securities.

4.2.1.1.2 **Interest Rate Variability**

Interest rate variability, as discussed in ASC 810-10-25-33, is analyzed on the basis of the facts and circumstances. The interest rate variability associated with a legal entity's assets is generally not a risk a legal entity is designed to create and pass along to its interest holders if a derivative instrument (e.g., an interest rate swap) is used to hedge such a risk. Therefore, interest rate variability that is hedged, or that arises from assets that will be held by the legal entity until maturity, should generally not be considered in the determination of whether an interest is a variable interest. However, this may not be the case if a derivative instrument used to hedge the risk is itself a variable interest (see Section 4.3.3).
Further, certain circumstances strongly indicate that a legal entity was designed to create and pass along interest rate risk to its interest holders, including the following:

- Variations in cash proceeds to be received upon anticipated sales of fixed-rate investments in an actively managed investment portfolio.
- Variations in the cash proceeds a legal entity will receive when it holds investments in a static pool that, by design, the potential VIE will be required to sell before maturity to satisfy its obligations.
- Variations in fair value resulting from an “interest rate mismatch.” ASC 810-10-55-68 through 55-70 give an example in which a legal entity holds fixed-rate assets and floating-rate debt. The interest rate mismatch is not hedged; thus, the legal entity was designed to expose the debt and equity investors to changes in fair value of the investments. Therefore, interest rate risk associated with changes in the fair value of fixed-rate periodic interest rate payments received must be considered.

Interests that absorb interest rate variability associated with any of these three circumstances generally would be considered variable interests. We believe that prepayment risk and interest rate risk should be considered collectively in the evaluation of the risks that a legal entity is designed to create and pass along to its interest holders. Said differently, we generally believe that in situations in which a legal entity is designed to create and pass along prepayment risk, the legal entity has also been designed to similarly create and pass along interest rate risk.

4.2.1.2 Performing Step 2

4.2.1.2.1 Factors to Consider

ASC 810-10-25-25 states that in performing step 2 of the by-design approach, the reporting entity should consider the following factors:

a. The activities of the legal entity
b. The terms of the contracts the legal entity has entered into
c. The nature of the legal entity’s interests issued
d. How the legal entity’s interests were negotiated with or marketed to potential investors
e. Which parties participated significantly in the design or redesign of the legal entity.

In addition, ASC 810-10-25-31 through 25-34 provide the following strong indicators of variability that the legal entity was designed to create and pass along to its interest holders:

- When the terms of the interests transfer all or a portion of the risk or return (or both) of certain assets or operations to the interest holder (see ASC 810-10-25-31).
- When the terms indicate that an interest is substantively subordinated. The amount of a subordinated interest relative to the overall expected losses by the entity is an indicator of whether subordination is substantive (see ASC 810-10-25-32).
- When fixed-rate investments are anticipated to be sold before maturity. This may result in variability to interest holders as a result of exposure to interest rate risk (see ASC 810-10-25-33).
- When the legal entity enters into arrangements such as derivatives to either reduce or eliminate certain variability (see ASC 810-10-25-34 and Section 4.3.3).

Interests that absorb the variability associated with these indicators are likely to be variable interests.
As part of the analysis, a reporting entity should consider the original formation documents, governing documents, any amendments to the original formation or governing documents, marketing materials, or other contractual arrangements entered into by the legal entity and provided to potential investors or other parties associated with the legal entity.

4.2.1.2.2 Terms of Interests Issued

Under the by-design approach, the reporting entity considers whether the terms of the interests issued transfer all or a portion of the risk of the legal entity to holders of those interests. The reporting entity should not make this determination solely on the basis of a legal or accounting designation. For example, if a reporting entity transfers financial assets to a legal entity that is accounted for as a financing, it would be inappropriate for that reporting entity to ignore any risks it has in the legal entity solely on the basis that the transferred financial assets were not derecognized for accounting purposes.

Further, in accordance with ASC 810-10-15-13A, the reporting entity only considers substantive terms, transactions, and arrangements, whether contractual or noncontractual, when applying the VIE model. Thus, the reporting entity disregards any term, transaction, or arrangement when applying the VIE model if the term, transaction, or arrangement does not have a substantive effect on any of the following:

- A legal entity's status as a VIE.
- A reporting entity's power over a VIE.
- A reporting entity's obligation to absorb losses or its right to receive the benefits of the legal entity.

4.2.1.2.3 Subordination

Understanding which interests issued by a legal entity constitute subordinated financial support is important in the evaluation of a legal entity for consolidation. The presence of substantive subordinated interests would be a strong indicator of the variability that the legal entity is designed to create and pass along to its interest holders.

4.2.1.2.3.1 Subordinated Financial Support

Subordinated financial support, as defined in ASC 810-10-20, is “[v]ariable interests that will absorb some or all of a [VIE’s] expected losses.” In general, all forms of financing are “subordinated financial support” unless the financing is the most senior class of liabilities and is considered “investment-grade.” Standard & Poor’s and Moody’s categorize investment-grade debt as that rated BBB or higher and Baa or higher, respectively. If the debt is not rated, it should be considered investment-grade only if it possesses characteristics that warrant such a rating. A reporting entity should carefully consider whether a nonrated instrument possesses the characteristics to be treated as investment-grade. Considerations may include how the yield of a nonrated instrument compares to that of comparable investment-grade debt or whether other subordinated classes of debt and equity are designed to absorb the expected losses of the legal entity in such a manner that the nonrated instrument is protected from losses.

The determination that non-investment-grade debt is subordinated financial support is based on the view that the debt holder is exposed to a more than remote chance of experiencing a credit loss. Therefore, unless the financing is investment-grade or is unrated and possesses the same characteristics as investment-grade debt, the financing should be considered subordinated.
**Example 4-1**

An investor holds a common-stock investment of $20 and a debt instrument of $80 in an entity. The only other variable interest is $40 of preferred stock held by an unrelated third party. The common and preferred stock are considered equity at risk in accordance with ASC 810-10-15-14(a); however, the debt instrument is rated B by Standard & Poor’s. In this example, the debt instrument is not investment-grade and would be considered subordinated financial support.

### 4.2.1.2.3.2 Evaluation of Substantiveness of Subordination

As noted above, the existence of substantive subordinated interests would be a strong indicator of the variability the entity is designed to create and pass along to its interest holders.

A reporting entity determines whether financing represents subordinated financial support on the basis of how such financing absorbs expected losses compared with other variable interests in the legal entity (e.g., whether there are other substantive subordinated classes of support that are designed to absorb expected losses). In general, the more disparity there is between the interests, the more likely it is that the subordinated class is substantive. In making this assessment, the reporting entity would consider all facts and circumstances, including:

- The amount and size of a subordinated interest compared with all other interests issued by the legal entity. That is, the size of a subordinated interest may be an indicator of whether the interest is designed to absorb the expected losses of the legal entity, which may in turn be an indicator that subordination is substantive.

- The interest's placement in the contractual priority of payments ("waterfall") that governs the distribution of the legal entity's cash flows. Distributions made to that interest in the later tiers of the waterfall may indicate that subordination is substantive.

- Credit ratings and relative yields (interest rates) of the interests issued. A larger differential between rates may be an indicator that subordination is substantive.

In addition, it is important for reporting entities to understand which variable interests constitute subordinated financial support when performing other aspects of the evaluation of a legal entity for consolidation. For example, ASC 810-10-15-17(d)(3) requires the reporting entity to assess whether it has provided more than half of a potential VIE's subordinated financial support when determining whether a potential VIE qualifies for the business scope exception (see Section 3.4.4.9). Further, ASC 810-10-15-14 requires the reporting entity to assess the design of the potential VIE's subordinated financial support when determining whether a potential VIE is a VIE (see Section 5.2.3).

### 4.3 Identifying a Variable Interest

**ASC 810-10 55-17** The identification of variable interests requires an economic analysis of the rights and obligations of a legal entity's assets, liabilities, equity, and other contracts. Variable interests are contractual, ownership, or other pecuniary interests in a legal entity that change with changes in the fair value of the legal entity's net assets exclusive of variable interests. The Variable Interest Entities Subsections use the terms expected losses and expected residual returns to describe the expected variability in the fair value of a legal entity's net assets exclusive of variable interests.
ASC 810-10-20 defines variable interests in a legal entity as "contractual, ownership, or other pecuniary interests in a VIE that change with changes in the fair value of the VIE’s net assets exclusive of variable interests." (For more information about the meaning of the term “net assets” under the VIE model, see Section C.2.1.) In addition, ASC 810-10-55-19 implies that variable interests absorb or receive the expected variability created by assets, liabilities, or contracts of a legal entity that are not, themselves, variable interests.

Generally, assets and operations of a legal entity create its variability while its liabilities and equity interests absorb that variability. Other contracts or arrangements entered into by the legal entity may appear both to create and to absorb variability (e.g., interest rate and foreign currency swaps) because they can be assets or liabilities depending on prevailing market conditions. In addition, for a hybrid instrument (see ASC 815-15-25-1), the host instrument and the embedded feature should be evaluated separately if the embedded feature is not clearly and closely related (see ASC 815-15-25-26 through 25-29) to the host (see Section 4.3.8 for further discussion).

Tables 4-1 and 4-2 below summarize common interests and indicate whether such interests would or would not generally be considered a variable interest. Determining whether a reporting entity's interest in another legal entity is a variable interest is only one step in applying the consolidation analysis. In the following situations, for example, holders of certain types of variable interests may be exempt from the VIE model's consolidation requirements or may require special treatment:

- A reporting entity, or the legal entity in which it has an interest, may qualify for one of the scope exceptions in ASC 810-10-15-12 or ASC 810-10-15-17 (see Sections 3.3 and 3.4, respectively).

- A reporting entity's variable interest in specified assets of a VIE may not be considered a variable interest in that legal entity unless, as described in ASC 810-10-25-55 and 25-56, the fair value of the specified assets is more than half of the total fair value of the VIE's assets or the holder has other variable interests in the VIE as a whole (except interests that are insignificant or have little or no variability). However, the reporting entity's variable interest may represent an interest in a "silo," as described in ASC 810-10-25-57 (see Chapter 6).

Table 4-1 lists examples (not all-inclusive) of financial instruments and other contracts with a legal entity that generally would be considered variable interests in that legal entity. The table also contains links to detailed discussions of each instrument. Note that (1) the determination of whether a particular interest is a variable interest depends on the design of the legal entity and the role of that interest and (2) “legal entity” means the potential VIE in which the reporting entity holds an interest.
<table>
<thead>
<tr>
<th>Financial Instruments or Other Contracts</th>
<th>Comments</th>
</tr>
</thead>
<tbody>
<tr>
<td>Trade accounts payable</td>
<td>Generally, liabilities of a legal entity represent variable interests in the legal entity. However, trade accounts payable that are short-term, fixed in amount, not junior to any other liability, and not concentrated with a small number of vendors generally should not be treated as a variable interest in the legal entity because such types of trade accounts payable are routine and have little variability. Trade accounts payable that do not fit this description may be a variable interest in the legal entity.</td>
</tr>
<tr>
<td>Long-term liabilities of a legal entity (e.g., fixed-rate debt, floating-rate debt, mandatorily redeemable preferred stock)</td>
<td>A debt holder's interest absorbs the variability in the value of the legal entity's assets because the debt holder is exposed to that legal entity's ability to pay (i.e., credit risk) and may be exposed to interest rate risk, depending on the design of the legal entity. See Section 4.3.2 for more information.</td>
</tr>
<tr>
<td>License and royalty arrangements</td>
<td>Generally, licenses, royalties, and similar arrangements represent variable interests in the legal entity since contractual terms typically require payments from the legal entity on the basis of the legal entity's revenues or other performance indicators. Therefore, such arrangements absorb, in part, the variability associated with changes in the legal entity's performance (i.e., changes in the fair value of the legal entity's net assets).</td>
</tr>
<tr>
<td>Equity of a legal entity (e.g., mezzanine equity, preferred stock, common stock, partnership capital)</td>
<td>If the equity interest is equity investment at risk pursuant to ASC 810-10-15-14(a) (see Section 5.2.2), it is a variable interest that absorbs the variability associated with changes in the legal entity's net assets. If the equity interest is not at risk pursuant to ASC 810-10-15-14(a), it is typically still a variable interest if it exposes the equity owner to the legal entity's variability. See Section 4.3.1 for more information.</td>
</tr>
<tr>
<td>Guarantees written by a reporting entity*</td>
<td>The guarantee agreement transfers all or a portion of the risk of specified assets (or liabilities) of the legal entity to the guarantor, resulting in the guarantor's absorbing the variability in values of those specified assets (or liabilities). See Section 4.3.4 for more information on analyzing guarantees. For a discussion of implicit variable interests, see Section 4.3.10.</td>
</tr>
<tr>
<td>Put options written by a reporting entity for a price other than fair value (e.g., fixed-price), and similar arrangements on specified assets owned by the legal entity*</td>
<td>Same as guarantees held by a legal entity; the put option writer is exposed to the variability in the values of the assets held by the legal entity if the strike price of the option is at a price other than fair value. However, whether a derivative or a contract with the characteristics of a derivative is a variable interest in a legal entity depends on the design of the legal entity and the characteristics of that instrument. See Section 4.3.4 for more information.</td>
</tr>
<tr>
<td>Stand-alone call options written by the legal entity on specified assets owned by that legal entity*</td>
<td>The holder of such a stand-alone call option absorbs positive variability in the value of the specified assets under that call option agreement in scenarios in which the call option would be exercised. However, whether a derivative or a contract with the characteristics of a derivative is a variable interest in the legal entity depends on the design of the legal entity and the characteristics of that instrument. See Section 4.3.7 for more information.</td>
</tr>
<tr>
<td>Fixed-price forward contracts to sell specified assets owned by a legal entity*</td>
<td>The counterparty to the forward contract absorbs variability in the fair value of the entity's specified assets underlying the forward contract. However, whether a derivative or a contract with the characteristics of a derivative is a variable interest in the legal entity depends on the design of the legal entity and the characteristics of that instrument. See Section 4.3.5 for more information.</td>
</tr>
</tbody>
</table>
### Table 4-1 — Examples of Variable Interests

<table>
<thead>
<tr>
<th>Financial Instruments or Other Contracts</th>
<th>Comments</th>
</tr>
</thead>
<tbody>
<tr>
<td>Total return swaps on specified assets owned by an entity*</td>
<td>The total return swap transfers all or a portion of the risk of specified assets (or liabilities) of the legal entity to the swap counterparty, resulting in the counterparty's absorbing the variability created by those specified assets (or liabilities). See Section 4.3.7 for more information.</td>
</tr>
<tr>
<td>Other derivatives</td>
<td>Whether a derivative is a variable interest in a legal entity depends on the design of the legal entity and the characteristics of that instrument. See Section 4.3.6 for additional guidance on determining whether other derivatives are variable interests.</td>
</tr>
<tr>
<td>Fees paid to a decision maker or service provider (see Section 4.4 for detailed discussion of analyzing decision-maker and service-provider fees)</td>
<td>These fees would be considered variable interests if they fail to meet one or more of the three conditions in ASC 810-10-55-37, which are as follows: 1. The fees are compensation for services provided and are commensurate with the level of effort required to provide those services. 2. The decision maker or service provider does not hold other interests in the VIE that individually, or in the aggregate, would absorb more than an insignificant amount of the VIE's expected losses or receive more than an insignificant amount of the VIE's expected residual returns. 3. The service arrangement includes only terms, conditions, or amounts that are customarily present in arrangements for similar services negotiated at arm's length. In addition, fees received related to assuming risk exposure are automatically a variable interest (see Section 4.4.1.1).</td>
</tr>
<tr>
<td>Stand-alone residual value guarantees of the legal entity's leased assets, written put options covering such leased assets (legal entity is the lessor), or both*</td>
<td>Stand-alone residual value guarantees transfer all or a portion of the risk of specified assets of the legal entity to the guarantor, resulting in the guarantor's absorbing the variability of those specified assets. Likewise, a written put option from the reporting entity to the legal entity is similar to a guarantee as the exposure to variability of the assets is the same.</td>
</tr>
<tr>
<td>Operating leases in which the legal entity is the lessor and there is an embedded residual value guarantee, a non-fair-value-based purchase option (i.e., a lessee call option), or both*</td>
<td>Because the embedded guarantee and purchase option are not clearly and closely related to the cash flows of the operating lease, the operating lease (i.e., the host contract) and the embedded items should be evaluated separately. The embedded items result in a variable interest,* as explained above. However, the host contract, an economic equivalent of an account receivable, creates variability for the legal entity and therefore is not a variable interest. See Section 4.3.9 for additional information, and see Section 4.3.10.1 for a discussion of an implicit variable interest.</td>
</tr>
<tr>
<td>Supply agreements with a variable cost component (when the legal entity is the supplier/seller)</td>
<td>For supply agreements designed to reimburse all or a portion of actual costs incurred, the counterparty to the supply agreement absorbs variability in the legal entity. Investors in the legal entity are partially protected from absorbing losses because the counterparty is reimbursing the legal entity for actual costs incurred. See Section 4.3.5.1 for more information.</td>
</tr>
</tbody>
</table>

* ASC 810-10-25-55 and 25-56 indicate that variable interests in a specified asset whose value is less than half of the total fair value of a VIE's assets are not considered variable interests in that legal entity unless the reporting entity also holds another interest in the legal entity (see Section 4.3.11 for a discussion of interests in specified assets). In addition, the variable interest could result in consolidation of a "silo" within a VIE (see Chapter 6).
Table 4-2 below lists examples (not all-inclusive) of financial instruments and other contracts with a legal entity that generally would not be considered variable interests in that legal entity (i.e., sources of variability). As in Table 4-1, note that determining whether a particular interest is a variable interest depends on the design of the legal entity and the role of that interest. Also note that “legal entity” means the potential VIE in which the reporting entity holds an interest.

**Table 4-2 — Examples of Sources of Variability**

<table>
<thead>
<tr>
<th>Financial Instruments or Other Contracts</th>
<th>Comments</th>
</tr>
</thead>
<tbody>
<tr>
<td>Assets of the legal entity</td>
<td>Assets typically are the major source of a legal entity's variability and are therefore not considered variable interests. However, see Table 4-1 for purchased guarantees, put options, and similar items that may be assets but are considered variable interests in the legal entity or in specified assets pursuant to ASC 810-10-25-55 and 25-56.</td>
</tr>
<tr>
<td>Options, guarantees, and similar financial instruments or contracts written by a legal entity</td>
<td>When the legal entity writes (sells) a put option, a guarantee, or a similar contract, those contracts normally create variability (e.g., the legal entity writes a put option on an asset owned by another party). Therefore, they are normally not variable interests to the counterparty. However, as described in Table 4-1, stand-alone call options written by the legal entity on specified assets owned by that legal entity would be variable interests.</td>
</tr>
<tr>
<td>Other derivatives</td>
<td>Whether a derivative is a variable interest in a legal entity depends on the design of the legal entity and the characteristics of that instrument. ASC 810-10-25-21 through 25-36 provide additional guidance on determining whether other derivatives are variable interests. See Section 4.3.6 for additional guidance on determining whether other derivatives are variable interests.</td>
</tr>
<tr>
<td>Fixed-price forward contracts to purchase assets not owned by the legal entity, fixed-price contracts to sell assets not owned by the legal entity</td>
<td>Typically, forward contracts related to assets the legal entity does not own create variability because they expose the legal entity to changes in the fair value of the assets underlying the forward purchase or sale contracts. See Section 4.3.5 for additional information.</td>
</tr>
<tr>
<td>Operating leases in which the legal entity is the lessor and there is no residual value guarantee, non-fair-value-based purchase option (i.e., a lessee call option), or other similar provision</td>
<td>The operating lease is the economic equivalent of an account receivable; therefore, it exposes the legal entity to variability (e.g., lessee performance). See Section 4.3.9 for additional information.</td>
</tr>
</tbody>
</table>
4.3.1 **Equity Interests**

<table>
<thead>
<tr>
<th><strong>ASC 810-10</strong></th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>55-22</strong> Equity investments in a VIE are variable interests to the extent they are at risk. (Equity investments at risk are described in paragraph 810-10-15-14.) Some equity investments in a VIE that are determined to be not at risk by the application of that paragraph also may be variable interests if they absorb or receive some of the VIE's variability. If a VIE has a contract with one of its equity investors (including a financial instrument such as a loan receivable), a reporting entity applying this guidance to that VIE shall consider whether that contract causes the equity investor's investment not to be at risk. If the contract with the equity investor represents the only asset of the VIE, that equity investment is not at risk.</td>
</tr>
</tbody>
</table>

Equity is almost always a variable interest, because it typically represents the most subordinated interest in the legal entity's capital structure. Therefore, equity will absorb the variability in the returns of the legal entity. In addition, equity investments may be variable interests even if it is determined that they are not at risk (equity investments at risk are described in Section 5.2.2) as long as they absorb or receive some of the legal entity's variability. However, if a legal entity has a contract with one of its equity investors (e.g., the legal entity has a financial instrument such as a loan receivable from the equity investor), the reporting entity would consider whether that contract causes the equity investor's investment not to be at risk. For example, if the contract with the equity investor (loan receivable) represents the only asset of the legal entity, that equity investment is not at risk and would not be considered a variable interest. Section 4.3.1.1 below discusses such a scenario. A reporting entity should carefully consider any conclusion that its equity interest does not represent a variable interest because of an offsetting contract.

### 4.3.1.1 Trust Preferred Security Arrangements and Similar Structures

Some companies (“sponsors”) use trusts or other legal entities (“vehicles”) as issuers of trust preferred securities. The structures are marketed under a variety of names, including trust originated preferred securities, monthly income preferred securities, and quarterly income preferred securities.

A conventional trust preferred arrangement is structured as follows:

- The sponsor invests a nominal amount of cash in exchange for common stock in a new legal entity (“trust”).
- The trust issues preferred securities to outside investors in exchange for cash (for an amount much larger than the cash invested by the sponsor).
- The proceeds received from the issuance of the common and preferred securities are loaned to the sponsor in exchange for a note (the note's terms are identical to those of the trust preferred securities).
- The sponsor’s parent provides a guarantee to the trust for the repayment of the note payable.
- The interest paid on the note by the sponsor to the trust is used by the trust to pay dividends on the preferred securities to outside investors.

In a conventional trust preferred arrangement, the trust has a contract (note receivable) with the sponsor, which is the trust's only asset. The common stock's absorption of expected losses depends solely on the sponsor's ability to repay the note. That is, the trust was designed to create and pass along only the credit risk of sponsor to the sponsor. As a result, the common stock is not equity at risk and not a variable interest. Therefore, the sponsor would not consolidate the trust under the provisions of the VIE model.
The following diagram illustrates a typical conventional trust preferred arrangement:

Specific facts and circumstances must be considered in the assessment of whether a reporting entity is able to analogize to a conventional trust preferred security arrangement outcome in the determination of whether the reporting entity holds a variable interest in a similar type of arrangement. Trust preferred arrangements can be structured in many ways and can result in different conclusions under the VIE model. The FASB staff has informally indicated that a reporting entity (sponsor) should consider whether the arrangement is designed such that the sponsor's interest in the trust constitutes an obligation to the trust or an investment in the trust.

The risks the trust was designed to create and pass along to the sponsor should be considered in the evaluation of the design of the legal entity. For example, in a conventional trust preferred security arrangement, the trust was designed to create and pass along the credit risk of the sponsor to the sponsor. The only asset of the trust is an obligation of the sponsor, and the sponsor controls the payment on its obligation. In a situation in which the trust holds the common stock of the sponsor, the trust is designed to create and pass along equity price risk to the sponsor. The sponsor does not necessarily control its own equity price because it is subject to a myriad of economic factors. As discussed in Examples 4-2 and 4-3, the FASB staff has expressed views on two scenarios similar to conventional trust preferred arrangements.
Example 4-2

Reverse Trust Preferred Structure

A trust receives preferred stock instead of holding a note receivable. The preferred stock is treated as debt in the financial statements of the sponsor under ASC 480-10. The investors have no recourse to the assets of the sponsor. The FASB staff's view is that, in a manner similar to a conventional trust preferred arrangement, the common stock is not equity at risk and is not a variable interest because the contract (preferred stock) with the sponsor represents the only asset of the trust and the preferred stock represents an obligation of the sponsor to the trust; therefore, the only asset of the trust is an obligation of the sponsor.
Example 4-3

Treasury Stock Financing Arrangement

A sponsor seeks to reduce the amount of its common stock held by third-party investors by establishing an SPE. The proceeds received by the SPE from the sponsor and the investment bank (from the issuance of the SPE's common stock and debt, respectively) are used to purchase the common stock of the sponsor on the open market. The SPE makes interest payments on the debt with the dividend proceeds from the sponsor's common stock. The investment bank is entitled to additional returns from the SPE if the share price of the sponsor's common stock exceeds specified thresholds.

The FASB staff's view is that the sponsor has a variable interest in the SPE because the SPE was designed to create and pass along equity price risk to the sponsor. Unlike the sponsor in Example 4-2, the sponsor in this example does not have an obligation to the SPE. Conversely, the sponsor has an investment in the SPE that absorbs variability because the common stock of the sponsor, purchased on the open market, is subject to economic factors not limited to the credit risk of the sponsor.

4.3.2 Beneficial Interests and Debt

**ASC 810-10**

55-23 Investments in subordinated beneficial interests or subordinated debt instruments issued by a VIE are likely to be variable interests. The most subordinated interest in a VIE will absorb all or part of the expected losses of the VIE. For a voting interest entity the most subordinated interest is the entity's equity; for a VIE it could be debt, beneficial interests, equity, or some other interest. The return to the most subordinated interest usually is a high rate of return (in relation to the interest rate of an instrument with similar terms that would be considered to be investment grade) or some form of participation in residual returns.

55-24 Any of a VIE's liabilities may be variable interests because a decrease in the fair value of a VIE's assets could be so great that all of the liabilities would absorb that decrease. However, senior beneficial interests and senior debt instruments with fixed interest rates or other fixed returns normally would absorb little of the VIE's expected variability. By definition, if a senior interest exists, interests subordinated to the senior interests will absorb losses first. The variability of a senior interest with a variable interest rate is usually not caused by changes in the value of the VIE's assets and thus would usually be evaluated in the same way as a fixed-rate senior interest. Senior interests normally are not entitled to any of the residual return.
Beneficial interests or debt instruments that represent financing instruments of a legal entity are almost always variable interests, even if the instruments are the most senior in the capital structure of the legal entity. As liabilities, these instruments are designed to absorb variability in the performance of the legal entity’s assets because the debt holder is exposed to that legal entity’s ability to pay (i.e., credit risk) and may be exposed to interest rate risk, depending on the design of the legal entity.

### 4.3.2.1 Netting of Instruments Other Than Equity

As discussed in Sections 4.3.1 and 4.3.1.1, certain equity instruments would not be variable interests because of an offsetting contract with the legal entity. At times, a subordinated beneficial interest or debt holder of a legal entity also will be the counterparty to an asset of that legal entity (e.g., it also borrowed money from the legal entity).

In the determination of a reporting entity’s exposure to variability, the netting concept described in ASC 810-10-55-22 may apply to subordinated beneficial interests or subordinated debt instruments if the contract with the investor is the only asset of the legal entity. If the legal entity has multiple assets, the investor must consider whether the combination of its rights and interests economically exposes it to risks of the legal entity. For example, while an investor’s investment in the legal entity may not be greater than the asset of the legal entity to which it is the counterparty, the subordination of its investment may economically be equivalent to a guarantee of the legal entity’s other assets.

#### Example 4-4

Entity X is funded as follows:
- Enterprise A: subordinated preferred stock — $100.
- Enterprise B: senior debt — $100.

Entity X uses the $200 to invest in a $100 note from A and to invest $100 in “other debt securities” issued by parties unrelated to A, B, or X.

The above facts indicate that A has two relationships with X: (1) the subordinated preferred stock, an absorber of variability (i.e., a variable interest), and (2) a note payable due to X, a creator of variability.

In this example, A has indirectly guaranteed the “other debt securities” by subordinating its interest. That is, if the “other debt securities” are not paid when due (or otherwise decrease in value if X does not plan to hold them until maturity), A will absorb that loss by paying on its $100 note payable to X and receiving the residual amount in X through its preferred stock investment. Therefore, A’s subordinated preferred stock represents a variable interest in X.
Note that in certain circumstances, netting a variable interest with an asset in which the reporting entity is the counterparty will result in minimal (i.e., could not be potentially significant from a benefit or loss perspective) or no risk to the variable interest holder. If the reporting entity has other variable interests in the legal entity, the variable interest holder would still need to assess whether its interest, in combination with those other interests, represents an obligation to absorb losses of the VIE or the right to receive benefits from the VIE that could potentially be significant in the primary-beneficiary assessment. (For more information, see Section 7.3.)

4.3.3 Certain Derivative Instruments

**ASC 810-10**

**Certain Derivative Instruments**

25-34 A legal entity may enter into an arrangement, such as a derivative instrument, to either reduce or eliminate the variability created by certain assets or operations of the legal entity or mismatches between the overall asset and liability profiles of the legal entity, thereby protecting certain liability and equity holders from exposure to such variability. During the life of the legal entity those arrangements can be in either an asset position or a liability position (recorded or unrecorded) from the perspective of the legal entity.

25-35 The following characteristics, if both are present, are strong indications that a derivative instrument is a creator of variability:

a. Its underlying is an observable market rate, price, index of prices or rates, or other market observable variable (including the occurrence or nonoccurrence of a specified market observable event).

b. The derivative counterparty is senior in priority relative to other interest holders in the legal entity.

25-36 If the changes in the fair value or cash flows of the derivative instrument are expected to offset all, or essentially all, of the risk or return (or both) related to a majority of the assets (excluding the derivative instrument) or operations of the legal entity, the design of the legal entity will need to be analyzed further to determine whether that instrument should be considered a creator of variability or a variable interest. For example, if a written call or put option or a total return swap that has the characteristics in (a) and (b) in the preceding paragraph relates to the majority of the assets owned by a legal entity, the design of the legal entity will need to be analyzed further (see paragraphs 810-10-25-21 through 25-29) to determine whether that instrument should be considered a creator of variability or a variable interest.

During the development of the by-design approach (see Section 4.2.1), the FASB debated whether certain derivative instruments, such as interest rate swaps and foreign currency swaps, should be considered a variable interest in a legal entity by the counterparty to the derivative. From an economic standpoint, these types of derivatives could be viewed as both creating and absorbing variability in a legal entity. For example, in an interest rate swap in which the legal entity pays a fixed rate and receives a variable rate, the counterparty is absorbing fair value variability and creating cash flow variability for the legal entity. Although it would be atypical for such an instrument to give the counterparty power over the legal entity, the principles in ASC 810-10-25-35 and 25-36 provide a framework for the counterparties to conclude that many of these instruments are not variable interests in the legal entity, which permits the counterparties to avoid further analysis of whether the legal entity is a VIE as well as the disclosures required by variable interest holders in a VIE.

Under the guidance in ASC 810-10-25-35 and 25-36, even if an instrument absorbs variability, it may be considered a creator of variability (i.e., not a variable interest) as long as it possesses the characteristics in ASC 810-10-25-35 and does not absorb all, or essentially all, of the variability related to a majority of the assets in the legal entity. The guidance is intended to be narrow in scope, applying only to derivative contracts that possess the characteristics in ASC 810-10-25-35.
The following flowchart illustrates how a reporting entity should apply the guidance in ASC 810-10-25-35 and 25-36:

1. **Does the instrument meet the definition of a derivative under ASC 815-10-15-83?**
   - If Yes, proceed to next step.
   - If No, the derivative instrument is not a variable interest.

2. **Is the derivative's underlying a market-observable variable?**
   - If Yes, proceed to next step.
   - If No, the derivative instrument should not be evaluated under ASC 810-10-25-35 and 25-36.

3. **Is the derivative counterparty senior in priority relative to other interest holders in the legal entity?**
   - If Yes, proceed to next step.
   - If No, the design of the legal entity should be analyzed further to determine whether the instrument is a creator of variability or a variable interest.

4. **Are changes in the fair value or cash flows of the derivative instrument expected to offset all, or essentially all, of the risk or return (or both) related to a majority of the assets (excluding the derivative instrument) or operations of the legal entity?**
   - If Yes, the derivative instrument should not be evaluated under ASC 810-10-25-35 and 25-36.
   - If No, in the absence of evidence to the contrary, the derivative instrument is not a variable interest.
The examples below illustrate the application of this guidance in certain situations. However, each transaction must be evaluated on the basis of its own facts and circumstances.

Example 4-5

An entity is created and financed with equity and variable-rate debt. The entity uses the proceeds to purchase BB-rated, fixed-rate securities. In addition, the entity enters into a "plain vanilla" interest rate swap with an unrelated third party (swap counterparty) that economically converts the fixed-rate securities to a variable rate. The notional amount of the swap is related to a majority of the assets in the entity. The swap counterparty has no other involvement with the entity. Assume that the interest rate swap possesses the following characteristics necessary to apply ASC 810-10-25-35 and 25-36:

- The interest rate swap meets the definition of a derivative, as described in ASC 815-10-15-83.
- The interest rate swap's underlying is an observable market rate.
- The swap counterparty is senior in priority to the entity's other interest holders.

The interest rate swap would probably be considered a creator of variability even though that swap absorbs interest rate variability. Although the notional amount of the swap is related to a majority of the assets of the entity, changes in the cash flows or fair value of the swap are not expected to offset all, or essentially all, of the risk or return (or both) related to the investments because the fair value and cash flows of the entity's investments are expected to be affected by risk factors other than changes in interest rate risk (e.g., credit risk of the BB-rated fixed-rate securities). The swap is designed to offset only interest rate risk, which does not constitute essentially all of the overall risk in the entity. Upon further analysis of the entity's design, it is determined that the interest rate swap would most likely not be considered a variable interest.

Example 4-6

An entity is created solely to hold common stock in a public company. The entity enters into a total return swap agreement with an unrelated third party in which (1) the entity pays the third party the return on common stock held by the entity as of certain predetermined dates and (2) the third party pays to the entity a fixed periodic amount. The enterprise has no other involvement in the entity. Assume that the swap possesses the following characteristics necessary to apply ASC 810-10-25-35 and 25-36:

- The swap meets the definition of a derivative in ASC 815-10-15-83.
- The swap's underlying (common stock of the entity) is publicly traded and therefore has an observable market price.
- The swap counterparty is senior in priority to the other interest holders.

While the total return swap possesses the characteristics described above, it offsets all, or essentially all, of the risk or return (or both) related to the majority of the assets (common stock) held by the entity because the fair value and cash flows of the entity's investment will vary solely with changes in the price of the common stock and are not expected to be affected by other risk factors. Under the swap agreement, the third party is absorbing all of that price risk, and the entity's residual interest holders are receiving a fixed return. Further analysis of the entity's design indicates that the total return swap would most likely be considered a variable interest (see also Example 4-13).

4.3.3.1 Meaning of the Term “Derivative Instrument”

The term derivative instrument, as used in ASC 810-10-25-35 and 25-36, refers only to instruments that meet the definition of a derivative in ASC 815-10-15-83. This was confirmed through discussions with the FASB staff. The term includes derivative instruments that might not be subject to the requirements of ASC 815 because they qualify for a scope exception in ASC 815-10-15-13. If a reporting entity holds an instrument that does not meet the ASC 815 definition of a derivative instrument, the reporting entity may not apply ASC 810-10-25-35 and 25-36 to determine whether that instrument is a variable interest.
If a reporting entity cannot apply the guidance in ASC 810-10-25-35 and 25-36, the reporting entity should further analyze the design of the legal entity under the VIE model to determine whether the instrument is a creator of variability or a variable interest.

Instruments that have derivative-like features, including guarantees, written put options, liquidity agreements, and forward contracts may be variable interests (see Sections 4.3.4 through 4.3.8 for additional information). While these instruments are subject to the provisions of the VIE model (regardless of whether they meet the definition of a derivative under ASC 815), only those instruments that meet the definition of a derivative under ASC 815 can apply ASC 810-10-25-35 and 25-36.

### 4.3.3.2 Meaning of the Term “Market-Observable Variable”

To apply ASC 810-10-25-35 and 25-36 to a derivative instrument, a reporting entity must determine whether the instrument possesses the following characteristics:

- The derivative instrument's underlying is an observable market rate, price, index of prices or rates, or other market-observable variable (including the occurrence or nonoccurrence of a specified market-observable event).
- The derivative counterparty is senior in priority to other interest holders in the legal entity.

To be a market-observable underlying, the market price, index, rate, or other variable underlying the derivative must be verifiable through an active, liquid market. A derivative with an underlying that is entity-specific (such as an entity's sales or service revenues) or that is not based on market events (such as the occurrence of a hurricane or an earthquake) would not meet the conditions in ASC 810-10-25-35 even if the contract met the definition of a derivative in ASC 815-10-15-83. This was confirmed through discussions with the FASB staff.

For example, commodities that trade on an active market, such as a commodities exchange, would be deemed to have an observable market price. However, a manufactured product that is sold by a reporting entity and its competitors in the marketplace, but not through an active, liquid market, would not be deemed to have an observable market price.

Another example is an interest rate index such as LIBOR, which would be considered a market observable interest rate index. Conversely, a bank's prime rate would not be considered a market observable interest rate index because it is determined by the bank and not in an active, liquid market.

The concept of “market observable variable” used in ASC 810-10-25-35 is not analogous to the notion of “observable inputs” used in ASC 820. Under ASC 820, “observable inputs” are not limited to variables that are verifiable in active, liquid markets.

### 4.3.3.3 Meaning of the Term “Essentially All”

A reporting entity must analyze an instrument that possesses characteristics specified in ASC 810-10-25-35, but that is expected to offset all or “essentially all” of the risk or return (or both) related to the majority of the assets or operations of the legal entity, to determine whether the instrument is a creator of variability or a variable interest.

In determining whether an instrument offsets “essentially all” of the risk or return of a majority of the assets of a legal entity, a reporting entity must consider whether the instrument offsets “essentially all” of the overall risk or return of a majority of the assets in the legal entity. The magnitude of the total risk or return should be considered, not whether a reporting entity's interest offsets some of each type of risk or return in the legal entity. The determination of whether an instrument offsets “essentially all” of the
risk or return (or both) is a matter of judgment — there are no strict quantitative guidelines. All facts and circumstances should be considered. This was confirmed through discussions with the FASB staff.

For example, assume that two types of risk are created in a legal entity: operating risk and credit risk. Operating risk accounts for 98 percent of the total risk in the legal entity. The reporting entity holds a derivative instrument in the legal entity that offsets all of the operating risk but none of the credit risk. There are no other arrangements between the legal entity and the reporting entity.

In this example, although the derivative instrument does not absorb each type of risk in the legal entity, it does offset essentially all of the overall risk in the legal entity because operating risk represents essentially all of the risk or return of a majority of the assets in the legal entity. Therefore, the reporting entity must further analyze the design of the legal entity to determine whether the derivative instrument is considered a creator of variability or a variable interest.

4.3.4 Guarantees, Puts, and Other Similar Arrangements

Since guarantees of assets or liabilities of a legal entity, written put options on the assets of the legal entity, and similar arrangements expose the counterparty to expected losses of the potential VIE, those arrangements are typically variable interests. However, whether such an arrangement is a variable interest in a legal entity depends on the design of the legal entity and the characteristics of that instrument. In addition, when analyzing guarantees, written put options, or similar arrangements related to assets of a potential VIE, reporting entities must determine whether the specified asset subject to the arrangement has a fair value that is less than half of the total fair value of a potential VIE’s assets (see Section 4.3.11). In addition, if the specified asset is less than half of the total fair value of the potential VIE’s assets, the arrangement is not considered a variable interest in the entire legal entity but could result in consolidation of a “silo” within a VIE (see Chapter 6).

Guarantees and similar arrangements in a potential VIE may not be explicitly identified by a reporting entity that has an implicit obligation to protect the assets or liabilities of a legal entity. For a discussion of implicit variable interests, see Section 4.3.10.

In situations in which an instrument such as a guarantee is written by the potential VIE, the instrument would generally create variability because it would expose the potential VIE to losses, and it would generally not represent a variable interest in the potential VIE.
4.3.5 Forward Contracts

<table>
<thead>
<tr>
<th><strong>ASC 810-10</strong></th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>55-27</strong> Forward contracts to buy assets or to sell assets that are not owned by the VIE at a fixed price will usually expose the VIE to risks that will increase the VIE’s expected variability. Thus, most forward contracts to buy assets or to sell assets that are not owned by the VIE are not variable interests in the VIE.</td>
</tr>
<tr>
<td><strong>55-28</strong> A forward contract to sell assets that are owned by the VIE at a fixed price will usually absorb the variability in the fair value of the asset that is the subject of the contract. Thus, most forward contracts to sell assets that are owned by the VIE are variable interests with respect to the related assets. Because forward contracts to sell assets that are owned by the VIE relate to specific assets of the VIE, it will be necessary to apply the guidance in paragraphs 810-10-25-55 through 25-56 to determine whether a forward contract to sell an asset owned by a VIE is a variable interest in the VIE as opposed to a variable interest in that specific asset.</td>
</tr>
</tbody>
</table>

Determining whether a forward contract is a variable interest depends on many factors, including the design of the legal entity, whether the asset is owned by the legal entity, the pricing of the forward contract, and the relationship of the fair value of the assets subject to the forward contract compared to the overall value of the legal entity’s assets. Typically, a fixed-price forward contract to sell assets owned by a legal entity would be a variable interest, because the counterparty to the forward contract absorbs variability in the fair value of the entity’s specified assets underlying the forward contract. Conversely, a fixed-price forward contract to purchase assets not currently owned by the legal entity, or a fixed-price contract to sell assets to the legal entity, would typically not be a variable interest, because these contracts tend to create variability for the legal entity.

In addition, a forward contract to purchase an asset by a reporting entity at the fair market value on future delivery dates is typically not a variable interest in the legal entity.

Finally, for forward contracts on assets owned by the legal entity, it is important to understand whether the specified asset subject to the arrangement has a fair value that is less than half of the total fair value of a potential VIE’s assets (see Section 4.3.11). In addition, the arrangement could result in consolidation of a “silo” within a VIE (see Chapter 6).
4.3.5.1 Purchase and Supply Arrangements

For purchase and supply arrangements in which a reporting entity enters into a contract either to purchase products from, or to sell products or services to, another entity, the reporting entity must first determine whether that contract should be evaluated as a derivative under ASC 810-10-25-35 and 25-36 (see Section 4.3.3). If the contract does not possess the necessary characteristics to be evaluated under that guidance, the reporting entity should determine whether the purchase and supply arrangement is a variable interest.

The determination of whether a purchase or supply contract is a variable interest will be based on what risks the legal entity is designed to be subject to and whether the role of the contract is to transfer to the counterparty of the purchase or supply agreement a portion of any of those risks from the equity, debt investors, or both. This is consistent with ASC 810-10-25-31, which states:

An analysis of the nature of the legal entity's interests issued shall include consideration as to whether the terms of those interests, regardless of their legal form or accounting designation, transfer all or a portion of the risk or return (or both) of certain assets or operations of the legal entity to holders of those interests. The variability that is transferred to those interest holders strongly indicates a variability that the legal entity is designed to create and pass along to its interest holders.

To determine whether the role of the contract is to transfer all or a portion of the risk or return (or both) of the assets or operations of the legal entity to the contract counterparty, the reporting entity must understand (1) the contract’s pricing, including whether it is fixed, variable, at-market value, or off-market; (2) the predominant risks in the legal entity; and (3) any other involvement the counterparty may have with the legal entity. For example, a purchase or supply agreement that is off-market, when entered into, will always be a variable interest because the pricing terms of the contract result in a reallocation of expected losses between the interest holders. See Section 4.3.5.2 for a further discussion of off-market contracts.

Table 4-3 below illustrates the application of this guidance to certain types of purchase and supply contracts. Determining whether a contract is a variable interest will ultimately depend on individual facts and circumstances. Assume that a legal entity is created to hold a manufacturing facility and is funded by two unrelated equity holders (Investor 1 and Investor 2). An unrelated reporting entity enters into either a purchase contract or a supply contract with the legal entity, as described in the table. The contract is priced at market terms as of its inception date. The reporting entity has no other involvement with the legal entity. Assume that ASC 810-10-25-35 and 25-36 do not apply because the contract is not associated with an observable market. The reporting entity has identified three potential risks in the legal entity: operating risk, credit risk, and product price risk.

<table>
<thead>
<tr>
<th>Type of Contract</th>
<th>Variable Interest?</th>
</tr>
</thead>
<tbody>
<tr>
<td>Fixed-price purchase contract in which the reporting entity purchases 100 percent of the manufactured product from the legal entity</td>
<td>No. The legal entity is designed to be subject to operating risk, credit risk, and raw material price risk. The role of the fixed-price purchase contract is not to transfer a portion of those risks from the equity investors to the reporting entity since the price paid under the contract does not change as a result of changes in operating costs, raw material costs, or default by the purchaser. The variability associated with those risks is designed to be absorbed by the equity investors.</td>
</tr>
</tbody>
</table>
Table 4-3 — Purchase and Supply Contracts

<table>
<thead>
<tr>
<th>Type of Contract</th>
<th>Variable Interest?</th>
</tr>
</thead>
<tbody>
<tr>
<td>Variable-price purchase contract in which the reporting entity purchases 100 percent of the manufactured product from the legal entity. The contract reimburses the legal entity for actual costs incurred in manufacturing the product</td>
<td>Yes. The legal entity is designed to be subject to operating risk, credit risk of the counterparty, and raw material price risk. The role of the variable-price purchase contract is to transfer raw material price risk and some portion of operating risk from the equity investors to the reporting entity. Risk of changes in raw material prices and a portion of operating costs will be borne by the purchaser.</td>
</tr>
<tr>
<td>Fixed-price supply contract in which the reporting entity supplies the raw materials to the legal entity</td>
<td>No. The legal entity is designed to be subject to operating risk and product price risk. The role of the fixed-price supply contract is not to transfer the product price risk from the equity investors to the reporting entity. Rather, the fixed-price supply contract creates variability since the legal entity has fixed its raw material price. Risk of changes in product prices and operating risk will be borne by the equity investors. (See Section 4.3.5.2 for a discussion of off-market supply agreements.)</td>
</tr>
<tr>
<td>Variable-price supply contract in which the reporting entity supplies the raw materials to the legal entity</td>
<td>No. The legal entity is designed to be subject to raw material price risk, operating risk, and product price risk. The role of the variable-price supply contract is not to transfer raw material price risk from the equity investors to the reporting entity. Risk of changes in raw material costs will be borne by the equity investors. (See Section 4.3.5.2 for a discussion of off-market supply agreements.)</td>
</tr>
</tbody>
</table>

4.3.5.2 Off-Market Supply Agreements

An off-market supply agreement will generally be a variable interest because it absorbs expected losses or receives expected residual returns that otherwise would be allocated to the investors. See also Example 5-37, which discusses the role of an off-market supply contract in an analysis of whether a legal entity is a VIE under ASC 810-10-15-14(b)(2).

Example 4-7

Investor A and Investor B (unrelated parties) each hold a 50 percent equity interest in a legal entity. The legal entity owns a manufacturing facility that makes a product that is sold in the marketplace. Investor A enters into an agreement to supply the legal entity with the raw materials it needs to manufacture its product. The pricing of the supply agreement is off-market as of the inception date of the contract. Assume that A and B have no other interests in the legal entity.

In this example, the supply agreement between A and the legal entity is a variable interest. The off-market supply agreement reallocates expected losses between A and B; therefore the contract absorbs expected losses and receives residual returns. For example, if the selling price of the raw materials were below market, A would absorb expected losses beyond its 50 percent equity interest because it is not receiving the normal profit on the sale. If the selling price of the raw materials were above market, A would receive, in the form of a premium, expected residual returns beyond its 50 percent equity interest.

This conclusion would not change if a nonequity investor were to enter into the off-market supply agreement with the legal entity. The off-market contract would reallocate expected losses or expected residual returns from the equity investors to the counterparty to the supply agreement.
4.3.5.3 **PPAs, Tolling Agreements, or Similar Arrangements**

Performing the variable interest assessment for PPAs and tolling arrangements can be particularly challenging. Before evaluating whether the arrangement is a variable interest, a reporting entity is required to determine whether the arrangement is:

- An operating lease that qualifies for the scope exception in ASC 810-10-55-39 for an operating lease.
- A derivative under ASC 815 that creates (rather than absorbs) variability in accordance with ASC 810-10-25-35 and 25-36.

Example 4-8 below illustrates a common example for a power plant entity.

**Example 4-8**

- A legal entity (PowerCo) is created to hold a generating facility and is funded by two unrelated equity holders and one unrelated debt holder.
- PowerCo uses the proceeds from the equity contributions and debt to purchase the generating facility.
- As a condition of lending, the debt holder requires PowerCo to enter into a 20-year forward contract to sell 100 percent of its output to a third party.
- PowerCo holds the title to the facility, which has a useful life of 40 years.

See Section E.5.2.1 for comprehensive guidance on how to evaluate these types of contracts.

4.3.5.4 **Purchase and Sale Arrangements for Real Estate**

The determination of whether a purchase and sale arrangement (PSA) for real estate is a variable interest will be based on identification of the risks the legal entity is designed to create and pass along to its interest holders and whether the role of the PSA is to transfer all or a portion of any of those risks from the investors to the PSA counterparty. To determine whether the role of the PSA is to transfer all or a portion of the risks to the counterparty, a reporting entity must understand (1) the pricing of the PSA (e.g., fixed, variable, at-market, or off-market), (2) the predominant risks of the legal entity, and (3) any other involvement the counterparty may have with the legal entity.

If the PSA is for an asset to be developed (i.e., requires the potential VIE to further develop the asset before the asset is delivered under the PSA), that asset would not be considered “owned by the VIE” because the assets being developed do not yet exist. Therefore, in accordance with ASC 810-10-55-27, a fixed-price PSA would generally not be a variable interest because it does not expose the purchaser to risks associated with real estate development cost overruns. On the other hand, in accordance with ASC 810-10-55-28, if the PSA was for a developed asset or land, the purchaser would generally have a variable interest as a result of the PSA because the purchaser is exposed to fluctuations in the fair value of the owned assets (unless the variable interest is in specified assets — see Section 4.3.11).
Example 4-8A

Company H entered into a PSA with Company P, a legal entity that develops retail real estate. Company H agreed to purchase a completed retail shopping center and related land for $11.5 million upon the completion of construction by P. Company H does not hold an equity interest in P, and P holds legal title to the land and to the construction under development, which comprise all of the assets held by P. The risks P was designed to create and pass along to its interest holders are related to real estate development, including changes in the price of materials or labor (or supply thereof), condemnation, and casualty. Since the price of the PSA with H is fixed, any cost overruns associated with the development are absorbed by the parties funding the construction, specifically the equity and debt investors of P.

Since H has no obligation to fund cost overruns associated with the development, H does not have a variable interest in P because the PSA is effectively a forward contract to buy assets that are not owned by P. Rather, the PSA is a creator of variability for P because it exposes P to the risk of generating a profit through development of the assets subject to the fixed-price forward contract.

Alternatively, if H had a forward contract to purchase land or other assets completed and owned by P, H would have a variable interest in P, subject to the determination of whether the interest is in specified assets under ASC 810-10-25-55 (see Section 4.3.11).

4.3.6 Other Derivatives

ASC 810-10

55-29 Derivative instruments held or written by a VIE shall be analyzed in terms of their option-like, forward-like, or other variable characteristics. If the instrument creates variability, in the sense that it exposes the VIE to risks that will increase expected variability, the instrument is not a variable interest. If the instrument absorbs or receives variability, in the sense that it reduces the exposure of the VIE to risks that cause variability, the instrument is a variable interest.

If a derivative instrument does not meet the narrow scope requirements of ASC 810-10-25-35 (see Section 4.3.3), a reporting entity should carefully consider the derivative's characteristics and the design of the legal entity to determine whether the derivative is a variable interest. Specifically, if the derivative exposes the legal entity to risk, the instrument is not a variable interest. Conversely, if the derivative reduces the legal entity's risk (i.e., protects others from being exposed), the instrument is a variable interest. Understanding the legal entity's design and the characteristics of the instrument are key in the reporting entity's analysis of whether a derivative, or a contract with the characteristics of a derivative, is a variable interest in the legal entity.

4.3.7 Total Return Swaps and Similar Arrangements

ASC 810-10

55-30 Derivatives, including total return swaps and similar arrangements, can be used to transfer substantially all of the risk or return (or both) related to certain assets of [a] VIE without actually transferring the assets. Derivative instruments with this characteristic shall be evaluated carefully.

A total return swap is a swap agreement in which one party makes payments to another party on the basis of the return of an underlying asset of a legal entity. Accordingly, a total return swap transfers all or a portion of the risk of specified assets (or liabilities) of the legal entity to the swap counterparty, resulting in the counterparty's absorption of the variability created by those specified assets (or liabilities). By its nature, a total return swap is typically a variable interest.
In addition, although it only absorbs returns of a legal entity, a call option written by the legal entity on specified assets owned by that legal entity typically represents a variable interest. The holder of such a stand-alone call option absorbs positive variability in the value of the specified assets under that call option agreement in scenarios in which the call option would be exercised.

Finally, for total return swaps and similar arrangements on assets owned by the legal entity, a reporting entity must determine whether the specified asset subject to the arrangement has a fair value that is less than half of the total fair value of a potential VIE's assets (see Section 4.3.11). If the specified asset is less than half, the arrangement is not considered a variable interest in the entire legal entity but could result in consolidation of a "silo" within a VIE (see Chapter 6).

4.3.8 Embedded Derivatives

<table>
<thead>
<tr>
<th>ASC 810-10</th>
</tr>
</thead>
<tbody>
<tr>
<td>55-31 Some assets and liabilities of a VIE have embedded derivatives. For the purpose of identifying variable interests, an embedded derivative that is clearly and closely related economically to its asset or liability host is not to be evaluated separately.</td>
</tr>
</tbody>
</table>

In the evaluation of whether an instrument is a variable interest, the determination of whether an embedded feature should be analyzed separately from the host should be consistent with the determination of whether the embedded feature is clearly and closely related to the host, as described in ASC 815. However, only the evaluation of whether the derivative is clearly and closely related to the host (and accordingly does not need to be bifurcated) is relevant. If the embedded feature would not be bifurcated solely because it meets the other criteria in ASC 815-15-25-1 or a scope exception to the derivative guidance, this would not affect whether the embedded derivative should be separately evaluated under the VIE model.

ASC 815-15-25-1 lists three criteria for separation of an embedded derivative from the host contract:

a. The economic characteristics and risks of the embedded derivative are not clearly and closely related to the economic characteristics and risks of the host contract.

b. The hybrid instrument is not remeasured at fair value under otherwise applicable [GAAP] with changes in fair value reported in earnings as they occur.

c. A separate instrument with the same terms as the embedded derivative would, pursuant to Section 815-10-15, be a derivative instrument subject to the requirements of Subtopic 815-10 and this Subtopic. (The initial net investment for the hybrid instrument shall not be considered to be the initial net investment for the embedded derivative.)

If the embedded derivative meets criterion (a) but not criterion (b) or (c), it should not be separated from its host contract and accounted for separately under ASC 815. However, because the embedded derivative is not clearly and closely related to the host contract, the reporting entity should evaluate the derivative separately to determine whether it is a variable interest under ASC 810-10. In other words, the VIE model only requires an analysis of whether the embedded derivative is clearly and closely related economically to its asset or liability host (i.e., ASC 815-15-25-1(a)). For additional guidance on deciding whether the embedded derivative is clearly and closely related economically to the asset or liability host, see ASC 815-15-25-16 through 25-29, and ASC 815-15-55-165 through 55-226.
Example 4-9

Enterprise A leases equipment (the only asset of Entity B) from B for a monthly payment of $10,000 for 36 months. The lease agreement includes a residual value guarantee provision in which A guarantees that the fair value of the leased equipment will be no less than $25,000 at the end of the 36-month term. The lease is an operating lease.

The hybrid instrument embodies a host contract (the operating lease) and an embedded derivative (the residual value guarantee provision). The residual value guarantee provision is not clearly and closely related to the operating lease because the economic characteristics and risks of the guarantee are different from those related to the cash flows of the operating lease. Therefore, the hybrid instrument meets the criterion in ASC 815-15-25-1(a). As a result, the residual value guarantee must be evaluated separately from the host operating lease (a source of variability) in accordance with ASC 810-10-55-31.

The operating lease host, an equivalent of an account receivable, creates variability and therefore is not a variable interest in B. However, the residual value guarantee transfers the risk of the legal entity’s asset to the lessee and accordingly is deemed a variable interest in B. Although the embedded feature (residual value guarantee) should not be separated from the operating lease host pursuant to ASC 815 because it fails to meet the criterion in ASC 815-15-25-1(c), it would still need to be analyzed separately under the VIE model.

4.3.9 Leases

ASC 810-10

55-39 Receivables under an operating lease are assets of the lessor entity and provide returns to the lessor entity with respect to the leased property during that portion of the asset’s life that is covered by the lease. Most operating leases do not absorb variability in the fair value of a VIE’s net assets because they are a component of that variability. Guarantees of the residual values of leased assets (or similar arrangements related to leased assets) and options to acquire leased assets at the end of the lease terms at specified prices may be variable interests in the lessor entity if they meet the conditions described in paragraphs 810-10-25-55 through 25-56. Alternatively, such arrangements may be variable interests in portions of a VIE as described in paragraph 810-10-25-57. The guidance in paragraphs 810-10-55-23 through 55-24 related to debt instruments applies to creditors of lessor entities.

4.3.9.1 Determining When a Lease Represents a Variable Interest — Potential VIE Is the Lessor

A leasing arrangement accounted for as an operating lease that does not include a residual value guarantee (or similar arrangement) or a fixed-price purchase option, and that is consistent with prevailing market terms at the inception of the lease, generally does not represent a variable interest because the arrangement is akin to a receivable of the lessor entity (the potential VIE). However, residual value guarantees or fixed-price purchase options are not the only provisions in a lease that may represent a variable interest in the lessor entity. All relationships and contractual arrangements between the lessee, lessor, and variable interest holders of the lessor should be evaluated to determine whether those relationships or arrangements result in the lessee’s absorption of expected losses or receipt of expected residual returns of the legal entity, even if the lessee has not entered into an arrangement that would be an explicit variable interest in the legal entity.

If there are other features in an operating lease, such as a purchase option, residual value guarantee, renewal option, or lease prepayment, it is important to understand whether the specified asset subject to the lease has a fair value that is less than half of the total fair value of a potential VIE’s assets. If the specified asset is less than half, the arrangement is not considered a variable interest in the entire legal entity but could result in consolidation of a “silhouette” within a VIE (see Chapter 6).
See Section 4.3.10.2 for a discussion of when an implicit guarantee may exist in a related-party lease.

Example 4-10

Company A leases property from an unrelated party, Company B. The lease requires fixed monthly payments and contains no residual value guarantees or fixed-price purchase options. At the inception of the lease, the terms were consistent with fair market rentals. The lease meets the classification for an operating lease. The operating lease is the only contractual relationship between A, B, and variable interest holders of B.

Company A’s operating lease would not be considered a variable interest in B.

The application of this guidance is the same for a reporting entity that accounts for the lease under the historical lease accounting model in ASC 840 or the revised lease accounting model resulting from ASU 2016-02 (codified in ASC 842). Although ASC 842 requires a lessee to account for most leases on its balance sheet, including those that have historically been accounted for as operating leases, the guidance also requires a lessee to classify a lease as an operating or finance lease for subsequent accounting and income statement characterization purposes. Therefore, since ASC 842 defines “operating lease” and does not amend the guidance in ASC 810 on such leases, ASC 842 does not affect the application of that guidance.

4.3.9.2 Capital Lease — Potential VIE Is the Lessor

Many question whether a capital lease represents a variable interest since ASC 810-10-55-39 only addresses operating leases. Further, some have questioned whether it is appropriate to consider whether the lessor entity should be consolidated by the lessee since a capital lease (or finance lease under ASC 842) results in the capitalization of the asset with a corresponding financing obligation under the provisions of ASC 840 or ASC 842. Unless the fair value of the assets subject to a lease represent less than half of the fair value of the lessor entity's assets (see Chapter 6), a capital lease represents a variable interest in the legal entity. Specifically, the capital lease arrangement is equivalent to a total return swap in which the lessee receives the benefits of the leased assets in exchange for making lease payments during the lease term. Accordingly, the lessee reporting entity is required to consider whether the lessor entity is a VIE and whether the potential VIE should be consolidated by the lessee reporting entity. While the accounting treatment of a capital lease or a finance lease under ASC 840 or ASC 842, respectively, may be similar to consolidation of the asset and related debt obligation under the VIE model, a holder of a variable interest must evaluate its interest in the potential VIE unless it qualifies for a scope exception in either ASC 810-10-15-12 or ASC 810-10-15-17.

Example 4-11

A lessor legal entity (a VIE) holds a single asset that it leases to a reporting entity. The lease contains a residual value guarantee and a purchase option. The lessee reporting entity accounts for the lease as a capital lease because the lease term is more than 75 percent of the economic life, and the minimum lease payments are in excess of 90 percent of the fair value of the leased property. Therefore, the lessee has a variable interest in the VIE. Further, the lessee reporting entity controls all aspects of operating the leased asset, as well as the right and obligation to purchase the property or remarket the property to a third party at the end of the lease. On the basis of facts and circumstances, a determination is likely to be made that the lessee reporting entity has the power over the most significant activities of the VIE and should consolidate the VIE because of the terms of the capital lease (see Chapter 7 for further discussion of identifying the primary beneficiary).

Although ASC 842 replaces the term “capital lease” in GAAP with “finance lease,” a reporting entity should apply ASC 842 to its finance leases in the same manner it applied ASC 840 to its capital leases.
4.3.10 Implicit Variable Interests

ASC 810-10

**Implicit Variable Interests**

25-49 The following guidance addresses whether a reporting entity should consider whether it holds an implicit variable interest in a VIE or potential VIE if specific conditions exist.

25-50 The identification of variable interests (implicit and explicit) may affect the following:
   a. The determination as to whether the potential VIE shall be considered a VIE
   b. The calculation of expected losses and residual returns
   c. The determination as to which party, if any, is the primary beneficiary of the VIE.

Thus, identifying whether a reporting entity holds a variable interest in a VIE or potential VIE is necessary to apply the provisions of the guidance in the Variable Interest Entities Subsections.

25-51 An implicit variable interest is an implied pecuniary interest in a VIE that changes with changes in the fair value of the VIE's net assets exclusive of variable interests. Implicit variable interests may arise from transactions with related parties, as well as from transactions with unrelated parties.

25-52 The identification of explicit variable interests involves determining which contractual, ownership, or other pecuniary interests in a legal entity directly absorb or receive the variability of the legal entity. An implicit variable interest acts the same as an explicit variable interest except it involves the absorbing and (or) receiving of variability indirectly from the legal entity, rather than directly from the legal entity. Therefore, the identification of an implicit variable interest involves determining whether a reporting entity may be indirectly absorbing or receiving the variability of the legal entity. The determination of whether an implicit variable interest exists is a matter of judgment that depends on the relevant facts and circumstances. For example, an implicit variable interest may exist if the reporting entity can be required to protect a variable interest holder in a legal entity from absorbing losses incurred by the legal entity.

25-53 The significance of a reporting entity's involvement or interest shall not be considered in determining whether the reporting entity holds an implicit variable interest in the legal entity. There are transactions in which a reporting entity has an interest in, or other involvement with, a VIE or potential VIE that is not considered a variable interest, and the reporting entity's related party holds a variable interest in the same VIE or potential VIE. A reporting entity's interest in, or other pecuniary involvement with, a VIE may take many different forms such as a lessee under a leasing arrangement or a party to a supply contract, service contract, or derivative contract.

25-54 The reporting entity shall consider whether it holds an implicit variable interest in the VIE or potential VIE. The determination of whether an implicit variable interest exists shall be based on all facts and circumstances in determining whether the reporting entity may absorb variability of the VIE or potential VIE. A reporting entity that holds an implicit variable interest in a VIE and is a related party to other variable interest holders shall apply the guidance in paragraphs 810-10-25-42 through 25-44B to determine whether it is the primary beneficiary of the VIE. The guidance in paragraphs 810-10-25-49 through 25-54 applies to related parties as defined in paragraph 810-10-25-43. For example, the guidance in paragraphs 810-10-25-49 through 25-54 applies to any of the following situations:
   a. A reporting entity and a VIE are under common control.
   b. A reporting entity has an interest in, or other involvement with, a VIE and an officer of that reporting entity has a variable interest in the same VIE.
   c. A reporting entity enters into a contractual arrangement with an unrelated third party that has a variable interest in a VIE and that arrangement establishes a related party relationship.
4.3.10.1 Implicit Variable Interests and “Activities Around the Entity”

The identification of explicit variable interests involves determining which contractual, ownership, or other pecuniary interests in a legal entity directly absorb or receive the variability of the legal entity. An implicit variable interest acts the same as an explicit variable interest except that it involves the absorbing or receiving (or both) of variability indirectly, rather than directly, from the legal entity. Therefore, the identification of an implicit variable interest involves determining whether a reporting entity may be indirectly absorbing or receiving the variability of the legal entity, which may be contractual or implicit.

At the 2004 AICPA Conference on Current SEC and PCAOB Developments, an SEC staff member, Associate Chief Accountant Jane Poulin, used the phrase “activities around the entity.” This expression refers to certain transactions and relationships between a direct interest holder in a potential VIE and other entities that indirectly alter the holder’s exposure to the risks-and-rewards profile of the direct interest holder’s investment. Ms. Poulin stated:

We have seen a number of questions about whether certain aspects of a relationship that a variable interest holder has with a variable interest entity (VIE) need to be considered when analyzing the application of FIN 46R [codified in ASC 810-10]. These aspects of a relationship are sometimes referred to as “activities around the entity.” It might be helpful to consider a simple example. Say a company (Investor A) made an equity investment in a potential VIE and Investor A separately made a loan with full recourse to another variable interest holder (Investor B). We have been asked whether the loan in this situation can be ignored when analyzing the application of FIN 46R. The short answer is no. First, FIN 46R specifically requires you to consider loans between investors as well as those between the entity and the enterprise in determining whether equity investments are at risk, and whether the at risk holders possess the characteristics . . . defined in paragraph 5(b) of FIN 46R [codified as ASC 810-10-15-14]. It is often difficult to determine the substance of a lending relationship and its impact on a VIE analysis on its face. You need to evaluate the substance of the facts and circumstances. The presence of a loan between investors will bring into question, in this example, whether Investor B’s investment is at risk and depending on B’s ownership percentage and voting rights, will influence whether the at risk equity holders possess the characteristics of a controlling financial interest.

Other “activities around the entity” that should be considered when applying FIN 46R include equity investments between investors, puts and calls between the enterprise and other investors and non-investors, service arrangements with investors and non-investors, and derivatives such as total return swaps. There may be other activities around the entity that need to be considered which I have not specifically mentioned. These activities can impact the entire analysis under FIN 46R including the assessment of whether an entity is a VIE as well as who is the primary beneficiary.

In another situation involving activities around the entity, investors became involved with an entity because of the availability of tax credits generated from the entity’s business. Through an arrangement around the entity, the majority of the tax credits were likely to be available to one specific investor. Accordingly, the staff objected to an analysis by this investor that 1) did not include the tax credits as a component of the investor’s variable interest in the entity and 2) did not consider the impact of the tax credits and other activities around the entity on the expected loss and expected residual return analysis. [Footnotes omitted]

At the 2005 AICPA Conference on Current SEC and PCAOB Developments, an SEC staff member, Mark Northan, emphasized that although FSP FIN 46(R)-5 (codified in ASC 810-10-25-49 through 25-54) focuses on noncontractual interests between related parties, implicit interests can also result from contractual arrangements between a reporting entity and unrelated variable interest holders. The SEC staff provided the following questions for reporting entities to consider in determining whether an implicit variable interest exists:

- Was the arrangement entered into in contemplation of the entity’s formation?
- Was the arrangement entered into contemporaneously with the issuance of a variable interest?
- Why was the arrangement entered into with a variable interest holder instead of with the entity?
- Did the arrangement reference specified assets of the [VIE]?
In a manner consistent with explicit variable interests, implicit variable interests and activities around the entity may affect the determination of whether:

- The legal entity is a VIE (see Chapter 5), including whether an investor’s equity is at risk, as described in ASC 810-10-15-14(a).
- The reporting entity should consolidate a VIE, including whether the reporting entity’s obligation to absorb losses or its right to receive benefits of the VIE could potentially be significant to the VIE (see Chapter 7).
- The reporting entity is required to provide the VIE disclosures (see Section 11.2).

In many cases, an implicit arrangement protects another variable interest holder from absorbing losses in a VIE, limits the holder’s ability to receive residual returns in a VIE, or both. Entities can also be designed to enable a reporting entity to circumvent the provisions of the VIE model by placing a party (often a related party) between the reporting entity and a VIE. In all cases, the role of a contract or arrangement in the design of a legal entity must be carefully evaluated, with a focus on its substance rather than on its legal form or accounting designation.

In the diagram below, anything within the circle represents arrangements that are potential explicit variable interests in Entity X. Arrangements between the investors and other entities outside the circle represent activities around the entity and are potential implicit or indirect variable interests in Entity X.

Investors A and B hold the only potential explicit variable interests in Entity X as a result of their equity investments of $1 million and Investor B’s asset guarantee. However, a reporting entity must consider whether any arrangements outside the circle represent an implicit variable interest in Entity X — that is, Reporting Entities C, D, E, and F should “look through” the counterparty to determine whether the role of their interest is to absorb variability of Entity X.

In addition to the questions discussed at the 2005 AICPA Conference on Current SEC and PCAOB Developments, questions for a reporting entity to consider in determining whether it holds an implicit variable interest include the following:

- Does a related party, through an ownership interest or by virtue of holding a significant role in the operations, have the ability to require (or have substantial influence over a decision to require) the reporting entity to reimburse the related party for its losses?
• Is there an economic motivation for the reporting entity to protect the related party or its variable interest holders from potential losses?

• Does the related-party relationship lack the following: (1) conflict-of-interest policies, (2) significant regulatory requirements that create disincentives, (3) fiduciary responsibility clauses, or (4) other similar restrictions that would prevent or deter a reporting entity from forcing a related party to absorb losses?

• Are there situations in which losses have been sustained in the past and, though not contractually required to be, were absorbed by the reporting entity?

• Are the unrelated parties (e.g., creditors, legal advisers) unaware of the relationships between the parties?

• Do other parties (e.g., a lender) involved with the reporting entity believe that there are implicit variable interests (e.g., guarantees)?

• Have implicit variable interests existed in past relationships that are similar to the current arrangement?

The determination of whether an interest is an implicit variable interest will depend on the role of that interest in the design of the legal entity and should be based on facts and circumstances. The examples below may help a reporting entity determine whether an interest represents an implicit variable interest.

**Example 4-12**

**Purchased Call and Written Put Option**

Investor A has a variable interest in Entity X. Investor A writes a call option to Entity C, an unrelated enterprise, that allows C to call A’s variable interest in X. In addition, A purchases a put option from Entity D (an unrelated entity) that allows A to put its variable interest in X to D.

In this example, neither C nor D holds an explicit variable interest in X. However, given the arrangements (call and put options) C and D have with A (a holder of an explicit variable interest in X), C and D will need to consider whether, on the basis of the facts and circumstances, they hold an implicit variable interest in X. Thus, C and D should consider the following:

• Whether the call and put options were entered into in contemplation of X’s formation.

• Whether the call and put options were entered into contemporaneously with the issuance of the variable interest held by A.

• The reason the call and put options were entered into with A and not X.

• Whether the call and put options concern specified assets of X.

• The specific terms and conditions of the call and put options (e.g., whether the strike price is fixed).
**Example 4-13**

**Total Return Swap**

Investor B holds an equity interest in Entity X that is a variable interest pursuant to the VIE model. Investor B enters into a total return swap agreement (the "swap") with Entity E, an unrelated enterprise, with the following terms and conditions:

- Investor B pays E any dividends it receives as a result of its equity interest in X.
- Investor B pays E the appreciation in the value of its equity interest in X, if any, on certain predetermined dates, including the maturity date of the swap.
- Enterprise E pays B the depreciation in the value of B's equity interest in X, if any, on those same dates.
- Enterprise E pays B a fixed periodic amount.
- Investor B must vote its interest in accordance with E's instructions.
- The swap matures in five years, a date in advance of the expected liquidation of X.
- Both B and E are constrained; that is, neither entity can transfer or assign its rights under the swap, and B cannot sell or transfer its variable interest in X. In the absence of such constraints, certain qualified parties would engage in those transactions.
- The likelihood that either B or E will fail to perform on any of the swap terms is remote.
- Investor B's variable interest is collateral for its obligation to E.

In this example, E does not have an explicit variable interest in X by virtue of the total return swap agreement described above. However, the total return swap arrangement between E and B (a holder of an explicit variable interest in X) requires E to consider whether it holds an implicit variable interest in X.

Entity E must therefore consider whether the total return swap results in E's absorption of the variability in X. Although E does not legally own the assets of X, the total return swap generally results in the transfer of risks and rewards of the assets in X from B to E. Therefore, E would probably conclude that it holds an implicit variable interest in X.

This conclusion is consistent with ASC 810-10-25-30 (see Section 4.3.7), which addresses interests that transfer all or a portion of the risk of specified assets (or liabilities) of a VIE (total return swaps are examples of such an arrangement). This risk transfer strongly indicates a variability that X was designed to create and pass along to its interest holders. Therefore, if E had entered into the total return swap agreement directly with X, E would most likely conclude that it holds a variable interest in X.

Note also that a principal-agency relationship exists between E and B, respectively, because B is required to vote its interest in X, as directed by E. When applying the provisions of the VIE model, B should attribute its interest to E.
Example 4-14

Back-to-Back Asset Guarantee

Investor B holds an equity interest in Entity X and provides an asset guarantee (guarantee of value) to X. The equity interest and guarantee of value are both variable interests pursuant to the VIE model. Investor B enters into a guarantee contract with Entity F (an unrelated entity) that requires F to pay B for any decrease in value of the assets held by X.

Although F does not have an explicit variable interest in X, the guarantee arrangement between F and B (a holder of an explicit variable interest in X) requires F to consider, on the basis of the facts and circumstances, whether it holds an implicit variable interest in X.

Entity F must therefore consider whether the guarantee contract results in F’s absorption of the variability in X. Although F does not legally own the assets of X, the guarantee contract generally results in the transfer of risks and rewards of the assets in X from B to F. Therefore, F would most likely conclude that it holds an implicit variable interest in X.

This conclusion is consistent with the guidance in ASC 810-10-55-30 (see Section 4.3.7), which addresses interests that transfer all or a portion of the risk of specified assets (or liabilities) of a VIE (asset guarantees are examples of such arrangements). The transfer of this risk is a strong indicator of a variability that X was designed to create and pass along to its interest holders. Therefore, if F had entered into the asset guarantee agreement directly with X, F would most likely conclude that it holds a variable interest in X.

4.3.10.2 Determining Whether an Implicit Guarantee (Variable Interest) Exists

Although the paragraphs below focus on whether an implicit guarantee exists in a leasing arrangement between related parties, reporting entities should analyze all arrangements to determine whether an implicit guarantee exists. An implicit variable interest may arise from transactions with any party, whether related (see ASC 810-10-25-49 through 25-54) or unrelated (see ASC 810-10-25-51).

As discussed in Section 4.3.9.1, an arrangement accounted for as an operating lease that does not include a guarantee (or similar arrangement) or fixed-price purchase option, and that is consistent with prevailing market terms at the inception of the lease, generally does not represent a variable interest to the lessee because the arrangement is a receivable of the lessor entity (the potential VIE). As a “receivable,” the arrangement creates, rather than absorbs, variability for the lessor entity. However, ASC 810-10-55-25 states, in part:

Guarantees of the value of the assets or liabilities of a VIE . . . or similar obligations such as . . . agreements (explicit or implicit) to replace impaired assets held by the VIE are variable interests if they protect holders of other interests from suffering losses. [Emphasis added]

In the VIE analysis, it is important to determine whether an implicit guarantee exists because (1) any implicit guarantee may cause the lessor entity to be a VIE under ASC 810-10-15-14(b)(2) (see Section 5.3.2) since such a guarantee protects the holders of the equity investment at risk from the expected losses of the entity and (2) the lessee (or its related parties) may hold a variable interest in the lessor VIE and should determine whether it is the lessor VIE’s primary beneficiary.

In situations in which a lessee does not have an explicit contract with a potential VIE (lessor entity) that qualifies as a variable interest (e.g., a guarantee), the lessee still may have a variable interest in the lessor entity through an implicit guarantee. This may be more relevant in a related-party leasing arrangement in which the holder of a potential variable interest in the lessor entity has the ability to exert influence on the lessee because of the related-party relationship. Whether an implicit guarantee exists depends on the relationship between the related parties and the nature of their variable interests in the lessor entity.
For example, such a guarantee may exist if the holder of a potential variable interest in the lessor entity has the ability to exert its influence on the lessee enterprise and thereby require the lessee to protect the lessor entity from losses on the leased property. Payments made to the lessor entity by the lessee, as well as payments made directly to an interest holder of the lessor, should be considered protection from such losses.

A reporting entity should consider all facts and circumstances in determining whether a related-party lessee (and its related parties) has provided an implicit guarantee of the lessor entity's property. To do so, the reporting entity would perform a two-step analysis.

Step 1 involves the determination of whether a party that has an ownership interest in, or that holds a significant role in the operations of, the lessee can require — or have substantial influence over a decision to require — the lessee to reimburse the lessor entity for losses it incurs in holding the leased asset.

For example, a decision to renew the lease at above-market rents or provide compensation directly to the variable interest holder could be indicative of an implicit guarantee. The guarantee is not limited to an outright reimbursement of the lessor for incurred losses.

Some examples of possible substantial influence under step 1 include the following:

- The lessee and the lessor are both controlled by a common parent.
- The lessor is wholly or substantially owned by a stockholder or group of stockholders who also own a stake in, and can exercise substantial influence over, the lessee entity.
- The lessor is wholly or substantially owned by a stockholder or group of stockholders who hold a significant role in the operations of the lessee entity (e.g., holding a senior officer or director position in the lessee or a controlling parent company).

If the step 1 conditions have been met, an implicit guarantee may exist. The reporting entity would then proceed to step 2.

In step 2, the reporting entity would consider whether:

- There is an apparent economic motivation for the lessee to protect the lessor entity or holders of variable interests in the lessor entity (ASC 810-10-55-25 indicates that a guarantee cannot exist unless it protects holders of other interests from suffering losses). For example, if the lessee and the lessor are both wholly owned subsidiaries of a common parent, the parent (as the shareholder in the lessor) would probably not benefit (on a net basis) from an implicit guarantee. Additional factors (not all-inclusive) to consider are whether (1) a tax strategy exists that creates an economic motivation or (2) parent financing is secured by assets of the lessee.
- The lessee (or its ultimate parent) has a fiduciary responsibility. For example, if the lessee has minority shareholders who would be disadvantaged by an implicit guarantee, the lessee may have a fiduciary responsibility that would prevent or significantly deter an implicit guarantee.
- The lessee (or its ultimate parent) has clear conflict-of-interest policies that would preclude the existence of an implicit guarantee. The reporting entity would also consider whether the policies are effectively monitored and violations are reported to a level in the organization that has authority over the violator.
- The lessee is subject to regulatory requirements that create significant disincentives or preclude transactions that result in an implicit guarantee, or would raise a question about the legality of an implicit guarantee.
• Similar transactions have occurred in the past in which a loss has been sustained, and no performance has constituted an implicit guarantee.
• Other unrelated parties (e.g., creditors, legal advisers) are aware of the existence of any implicit guarantee between the related parties to the transaction.

In addition, at the 2005 AICPA Conference on Current SEC and PCAOB Developments, the SEC staff indicated that preparers should consider the following questions (not all-inclusive) in identifying implicit variable interests:

• Was the arrangement entered into in contemplation of the entity’s formation?
• Was the arrangement entered into contemporaneously with the issuance of a variable interest?
• Why was the arrangement entered into with a variable interest holder instead of with the entity?
• Did the arrangement reference specified assets of the [VIE]?

**Example 4-15**

**Implicit Guarantee Exists**

Operating Company (Operating) is a nonpublic entity that leases real estate under a long-term operating lease from a related party, Real Estate, which is wholly owned by the majority shareholder (Shareholder) of Operating. Real Estate (a VIE) was capitalized with $30,000 of equity from Shareholder and $970,000 of bank debt, with recourse to the assets of Real Estate and to the personal assets of Shareholder. Real Estate owns no assets other than the real estate asset leased to Operating. The lease contains no explicit guarantees of the residual value of the real estate or fixed-price purchase options. At the inception of the lease, the terms were consistent with fair market rentals. The lease meets the criteria for classification as an operating lease. The operating lease is the only contractual relationship between Operating and Real Estate.

The following diagram depicts the relationship described above:
Example 4-15 (continued)

ASC 810-10-55-25 indicates that guarantees of the value of the assets or liabilities of a VIE may be explicit or implicit. Although the operating lease itself does not contain a contractual guarantee of the value of Real Estate’s leased asset, as a result of the related-party relationship between the two entities, the following two-step analysis must be performed to determine whether Operating has provided an implicit guarantee of Real Estate’s leased asset to protect Shareholder’s investment in Real Estate and Shareholder’s personal guarantee of Real Estate’s debt:

- **Step 1** — Shareholder can require Operating to reimburse it or Real Estate for losses incurred through its controlling interest. Therefore, step 2 must be performed.
- **Step 2** — Shareholder has an economic motivation to require Operating to reimburse it for losses incurred by Real Estate because the minority interest holder will incur a portion of the losses pushed to Operating. If Shareholder does not have a fiduciary responsibility or clear conflict of interest policy that would preclude the pushing of losses to Operating, and no factors indicate that Shareholder is unable to require performance, an implicit guarantee exists. The implicit guarantee would result in Operating’s holding a variable interest in Real Estate (this implicit guarantee of Real Estate’s leased asset exists whether the guaranteed payment is made directly to Real Estate or directly to Shareholder). Although Operating and Shareholder are related, both Operating (i.e., through its implicit guarantee of the assets of Real Estate) and Shareholder (i.e., through its equity interest and personal guarantee of the debt) must first follow the guidance in ASC 810-10-25-38A to determine whether either entity individually meets both the power and economics characteristics and should consolidate Real Estate. If neither Operating nor Shareholder individually meets both characteristics, they must follow the guidance in ASC 810-10-25-42 through 25-44 to determine whether one of the parties should consolidate Real Estate.

Example 4-16

**Implicit Guarantee Does Not Exist**

Enterprise H is a public holding company with two wholly owned subsidiaries, Entity R and Enterprise O. Enterprise O is a regulated operating entity that must file stand-alone financial statements with its regulator. The regulator requires that all related-party transactions entered into by O be on market terms and imposes certain restrictions on dividends that O can pay. Entity R is a real estate company whose only asset is a building leased to O. The lease is a long-term, market-rate operating lease with no explicit residual value guarantee or purchase option. Entity R is funded by 20 percent equity issued to H and an 80 percent intercompany loan from H. Since an operating lease is generally not a variable interest under ASC 810-10-55-39 and since O and R are related parties, O must consider whether it has provided an implicit guarantee to R because of H’s potential ability to require O to fund any losses of R. The following two-step analysis must be performed:

- **Step 1** — Enterprise H, because of its 100 percent ownership in O, can control O. Therefore, step 2 must be performed.
- **Step 2** — The following assessment would be conducted:
  - Enterprise O and Entity R are both wholly owned subsidiaries of Enterprise H. Therefore, the parent would not benefit (on a net basis) from an implicit guarantee.
  - Enterprise O is subject to regulatory requirements that require transactions with related parties to be conducted at market terms. In addition, there are significant disincentives within the regulatory requirements for capital transactions.

If no other overriding factors indicate that H is able to require O to protect it from losses incurred on its investment in R, an implicit guarantee does not exist.
In March 2014, the FASB issued ASU 2014-07 in response to a consensus reached by the PCC. The ASU provides an accounting alternative to the VIE model for private entities that have a leasing transaction with a lessor entity under common control. The ASU does not apply to public business entities, NFPs, or employee benefit plans within the scope of ASC 960 or ASC 965. In addition, in October 2018, the FASB issued ASU 2018-17, which broadens the existing accounting alternative available to private companies by allowing all legal entities under common control to elect not to apply the VIE guidance as long as certain criteria are met. See Section 3.5 for more information about qualifying for this accounting alternative.

4.3.11 Variable Interests in Specified Assets

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25-55 A variable interest in specified assets of a VIE (such as a guarantee or subordinated residual interest) shall be deemed to be a variable interest in the VIE only if the fair value of the specified assets is more than half of the total fair value of the VIE’s assets or if the holder has another variable interest in the VIE as a whole (except interests that are insignificant or have little or no variability). This exception is necessary to prevent a reporting entity that would otherwise be the primary beneficiary of a VIE from circumventing the requirement for consolidation simply by arranging for other parties with interests in certain assets to hold small or inconsequential interests in the VIE as a whole. The expected losses and expected residual returns applicable to variable interests in specified assets of a VIE shall be deemed to be expected losses and expected residual returns of the VIE only if that variable interest is deemed to be a variable interest in the VIE.

25-56 Expected losses related to variable interests in specified assets are not considered part of the expected losses of the legal entity for purposes of determining the adequacy of the equity at risk in the legal entity or for identifying the primary beneficiary unless the specified assets constitute a majority of the assets of the legal entity. For example, expected losses absorbed by a guarantor of the residual value of leased property are not considered expected losses of a VIE if the fair value of the leased property is not a majority of the fair value of the VIE’s total assets.

Pending Content (Transition Guidance: ASC 842-10-65-1)

25-56 Expected losses related to variable interests in specified assets are not considered part of the expected losses of the legal entity for purposes of determining the adequacy of the equity at risk in the legal entity or for identifying the primary beneficiary unless the specified assets constitute a majority of the assets of the legal entity. For example, expected losses absorbed by a guarantor of the residual value of underlying asset are not considered expected losses of a VIE if the fair value of the underlying asset is not a majority of the fair value of the VIE’s total assets.
The flowchart below outlines the reporting entity's consolidation analysis depending on whether it has a variable interest in specified assets of a legal entity. It is assumed in the flowchart that the specified assets are not in a silo. If a silo exists, a reporting entity may need to perform a separate consolidation analysis for the separate silo rather than consider whether a party has a variable interest in a specified asset in the overall legal entity. See Chapter 6 for additional information on silos.

1. **Does the reporting entity have a variable interest in specified assets of a legal entity?** (See Section 4.3.11.1.)
   - **No**
   - **Yes**

2. **Is the fair value of the specified assets more than 50 percent of the fair value of all assets of the legal entity?** (See Section 4.3.11.2.)
   - **Yes**
   - **No**

3. **Does the reporting entity have another variable interest in the legal entity as a whole (unless that interest is insignificant or has little or no variability)?** (See Sections 4.3.11.3 and 4.3.11.4.)
   - **Yes**
   - **No**

**Stop consolidation analysis.**

Apply the consolidation analysis to the legal entity as a whole.
4.3.11.1 Identifying Interests in Specified Assets

An interest in specified assets is a contractual, ownership, or other pecuniary interest whose value changes according to changes in the value of selected assets of the legal entity. In other words, the risks and returns that are associated with the interest are tied to a specific asset or group of assets and not to the risks and returns of the legal entity as a whole. The existence of such interests is the means by which a subset of assets or activities may be effectively segregated from the remaining assets or activities of the legal entity. Interests that typically are considered interests in specified assets include the following:

- A fixed-price purchase option or residual value guarantee on a leased asset. Consider an example in which a reporting entity leases equipment from a legal entity, and the terms of the lease allow the reporting entity to purchase the equipment at the end of the lease term for a fixed price. In this case, the reporting entity has a variable interest in specified assets (i.e., the leased equipment) of the legal entity.

- Nonrecourse debt. Consider an example in which a reporting entity provides a loan to a legal entity, and the loan is repaid solely from the cash flows that come from specified securities held by the legal entity. In this case, if the securities do not fully repay the loan or if the legal entity is bankrupt, the reporting entity has no recourse to other assets of the legal entity, and the loan is an interest in specified assets (the specified securities).

- Credit guarantees and put options held by the legal entity. Consider an example in which a legal entity holds a portfolio of receivables and purchases a credit guarantee from a third party. In this case, the third party has an interest in specified assets (the portfolio of receivables).

- Certain types of equity or other residual interests. Consider an example in which a reporting entity holds preferred stock, such as so-called tracking or targeted stock, that pays a return on the basis of specified activities of the legal entity.

- A forward contract to purchase or sell an asset at a price other than fair value.

To the extent that a reporting entity's variable interest is not in specified assets, the reporting entity would apply the VIE model to the legal entity as a whole to determine whether the legal entity is a VIE. In performing this assessment, the reporting entity should consider the effect of variable interests in specified assets that may be held by other parties involved with the legal entity. See Section 4.3.11.3 for further discussion.

Example 4-17

Enterprise A owns 100 percent of the equity in Entity X, which is a VIE. Entity X is a lessor of three commercial real estate assets, each of which is approximately 33 percent of the fair value of X. Each lease contains a residual value guarantee of the asset at the end of the lease term. The residual value guarantees would be considered interests in specified assets under ASC 810-10-25-55.

Therefore, the expected losses absorbed by the residual value guarantees would be excluded from the expected losses of the VIE before the evaluation of the design of X and the risks that X was designed to create and pass along to its variable interest holders.

4.3.11.2 Variable Interests in Specified Assets of the Legal Entity That Are More Than 50 Percent of the Total Fair Value of the Legal Entity's Assets

A reporting entity should carefully consider whether a variable interest is in a specified asset or in the legal entity as a whole. For example, a provider of a guarantee does not always hold a variable interest in the guaranteed legal entity. However, a guarantee of any portion of a legal entity's liabilities is generally considered a variable interest in the legal entity. ASC 810-10-25-55 explains that a reporting entity has a
variable interest in the legal entity if the fair value of the specified assets is more than 50 percent of the total fair value of the legal entity's assets.

A literal read of the literature would suggest that guarantees of the legal entity's assets (e.g., a residual value guarantee of a leased asset) that represent more than half of the total fair value of the legal entity's assets are considered variable interests in the legal entity; the reporting entity would therefore apply the VIE model in ASC 810-10 to the legal entity as a whole to determine whether the legal entity is a VIE. However, we believe that there are scenarios in which a class of variable interest may exist that is exposed to the variability in a specified group of assets and that the holders of such interests have no recourse to the assets of the legal entity. Rather, their recourse is limited to the specified group of assets. Further, essentially none of the returns of the specified assets will accrue to the legal entity as a whole or to holders of other classes of variable interests in specified assets. In such circumstances, the holders of the guarantee would need to consider the silo provisions in ASC 810-10-25-57 to determine (1) whether a silo exists and (2) whether the reporting entity should consolidate the silo. A silo may exist in such cases even if the specified group of assets represents more than 50 percent of the fair value of the legal entity's assets as a whole. See Chapter 6.

If the variable interest in specified assets is not more than 50 percent of the total fair value of the legal entity's assets, the guarantee is considered a variable interest in specified assets rather than a variable interest in the legal entity (as long as the reporting entity, including its related parties, has no other variable interest in the legal entity, as further discussed in Sections 4.3.11.3 and 4.3.11.4). In such instances, the reporting entity holding such an interest generally would not be the primary beneficiary of the legal entity. However, the holder of an interest in specified assets must consider the silo provisions of ASC 810-10-25-57 to determine whether a silo exists and whether the reporting entity should consolidate the silo. If, after considering the provisions in ASC 810-10-25-57, the reporting entity determines that a silo does not exist, the reporting entity would stop its consolidation analysis.

In the calculation of whether a reporting entity's variable interest in specified assets is more than 50 percent of the total fair value of the legal entity's assets, it is appropriate to deduct the fair value of a silo's assets, if any, from the total assets of the host entity before such a computation is performed. See Section 6.2.2 for further discussion.

### 4.3.11.3 Considering a Reporting Entity's Other Interests

ASC 810-10-25-55 explains that if a reporting entity has (1) a variable interest in specified assets of a legal entity and (2) another variable interest in the legal entity as a whole, the reporting entity's interest in specified assets is considered a variable interest in the legal entity as a whole. However, if the holder's other interest in the legal entity as a whole is insignificant or deemed to have little or no variability, the holder's interest in specified assets would not be considered a variable interest in the legal entity as a whole.

A reporting entity should consider all facts and circumstances associated with its interests in the legal entity in determining whether its interest in the legal entity as a whole is significant or will absorb more than little or no variability in the legal entity's cash flows. When determining significance, the reporting entity should consider quantitative factors (e.g., the fair value of the “non-guarantee” interest in relation to the fair value of other assets in the legal entity) and qualitative factors (e.g., specific rights or obligations borne by the interest in the legal entity and the purpose served by this interest in the design of the legal entity). Little or no variability would be expected to be a lower threshold than “insignificant,” as used in ASC 810-10-55-37 (see Section 4.4.2.1). The objective is to determine whether the other interest held by the party with an interest in specified assets is a substantive interest in the legal entity as a whole or whether the interest was designed to circumvent a consolidation conclusion that would otherwise be reached under the VIE model in ASC 810-10. A reporting entity will make this
determination by considering all the interests in the legal entity and the risks that the legal entity was
designed to pass along to its interest holders.

In addition to potentially affecting the determination of the primary beneficiary of a VIE, identifying
whether an interest in specified assets is an interest in the legal entity as a whole could influence the
determination of whether the legal entity is a VIE. This is because the expected losses and expected
residual returns that would be attributable to the interest holder in specified assets are excluded from
the calculation of the expected losses and expected residual returns of the legal entity as a whole.
Therefore, ASC 810-10-25-55 prevents a reporting entity from structuring the terms of the interests
issued by a legal entity to achieve a desired accounting result regarding whether the legal entity is a VIE
and whether the reporting entity is the primary beneficiary of the VIE.

Example 4-18

Assume the same facts as in Example 4-17, except that (1) Enterprise A owns 99.97 percent of the equity in
Entity X and (2) X requires that, in conjunction with entering into the lease, each lessee invest in 0.01 percent of
the equity of X.

Since the equity held by each lessee has little or no variability, the residual value guarantees would still
be considered interests in specified assets under ASC 810-10-25-55. However, if the requirement was for
each lessee to invest in 5 percent of the equity of X, such equity interest would be considered a more-than-
insignificant other interest. This would result in the conclusion by each lessee that its combined interest
(residual value guarantee and equity interest) is a variable interest in the entity as a whole as opposed to
specified assets of the legal entity.

4.3.11.4 Considering a Related Party’s Interest

We believe that in assessing the guidance in ASC 810-10-25-55, a reporting entity should consider its
interests (direct, indirect, and implicit) and interests held by its related parties to determine its variable
interest in a legal entity. There is no specific guidance in ASC 810-10 on how to consider variable
interests held by a related party in the assessment of whether a reporting entity has a variable interest
in specified assets. Therefore, a reporting entity could analogize to the related-party guidance in ASC
810-10-55-37D when considering such interests. For example, a reporting entity would consider its
related party’s interest on a proportionate basis unless the related party is under common control.1 If
a related party is under common control, the reporting entity should carefully evaluate the facts and
circumstances.

1 In October 2018, the FASB issued ASU 2018-17, which requires all indirect interests held through related parties, regardless of whether they are
under common control, to be considered proportionately in the determination of whether a service provider’s fee represents a variable interest.
See Section 4.4.2.3.2 for further information.
Example 4-19

Enterprises A and B are related parties (see Chapter 8) but are not under common control. Individually, (1) A has a variable interest in VIE X as a whole and (2) B has a variable interest in specified assets of X because B provides a credit guarantee on X's receivables, which have a fair value that is less than 50 percent of the fair value of X's total assets. Further, B has a 20 percent direct ownership interest in A. Because A and B are related parties, B has an additional indirect interest in X through its direct 20 percent ownership in A. Unless B's proportionate interest in X (i.e., through B's 20 percent interest in A and A's variable interest in X) is insignificant or has little or no variability, B would conclude that it has a variable interest in X in accordance with ASC 810-10-25-55 because B has a variable interest in specified assets of X and another variable interest in the VIE as a whole.

4.4 Decision-Maker or Service-Provider Fees

**ASC 810-10**

**55-37** Fees paid to a legal entity's decision maker(s) or service provider(s) are not variable interests if all of the following conditions are met:

a. The fees are compensation for services provided and are commensurate with the level of effort required to provide those services.

b. Subparagraph superseded by Accounting Standards Update No. 2015-02.

c. The decision maker or service provider does not hold other interests in the VIE that individually, or in the aggregate, would absorb more than an insignificant amount of the VIE's expected losses or receive more than an insignificant amount of the VIE's expected residual returns.

d. The service arrangement includes only terms, conditions, or amounts that are customarily present in arrangements for similar services negotiated at arm's length.

e. Subparagraph superseded by Accounting Standards Update No. 2015-02.

55-37B Facts and circumstances should be considered when assessing the conditions in paragraph 810-10-55-37. An arrangement that is designed in a manner such that the fee is inconsistent with the decision maker's or service provider's role or the type of service would not meet those conditions. To assess whether a fee meets those conditions, a reporting entity may need to analyze similar arrangements among parties outside the relationship being evaluated. However, a fee would not presumptively fail those conditions if similar service arrangements did not exist in the following circumstances:

a. The fee arrangement relates to a unique or new service.

b. The fee arrangement reflects a change in what is considered customary for the services.

In addition, the magnitude of a fee, in isolation, would not cause an arrangement to fail the conditions.

55-37C Fees or payments in connection with agreements that expose a reporting entity (the decision maker or the service provider) to risk of loss in the VIE would not be eligible for the evaluation in paragraph 810-10-55-37. Those fees include, but are not limited to, the following:

a. Those related to guarantees of the value of the assets or liabilities of a VIE

b. Obligations to fund operating losses

c. Payments associated with written put options on the assets of the VIE

d. Similar obligations, such as some liquidity commitments or agreements (explicit or implicit) that protect holders of other interests from suffering losses in the VIE.

Therefore, those fees should be considered for evaluating the characteristic in paragraph 810-10-25-38A(b). Examples of those variable interests are discussed in paragraphs 810-10-55-25 and 810-10-55-29.
ASC 810-10 (continued)

55-37D For purposes of evaluating the conditions in paragraph 810-10-55-37, any interest in an entity that is held by a related party of the decision maker or service provider should be considered in the analysis. Specifically, a decision maker or service provider should include its direct economic interests in the entity and its indirect economic interests in the entity held through related parties, considered on a proportionate basis. For example, if a decision maker or service provider owns a 20 percent interest in a related party and that related party owns a 40 percent interest in the entity being evaluated, the decision maker’s or service provider’s interest would be considered equivalent to an 8 percent direct interest in the entity for the purposes of evaluating whether the fees paid to the decision maker(s) or the service provider(s) are not variable interests (assuming that they have no other relationships with the entity). Indirect interests held through related parties that are under common control with the decision maker should be considered the equivalent of direct interests in their entirety. The term related parties in this paragraph refers to all parties as defined in paragraph 810-10-25-43, with the following exceptions:

a. An employee of the decision maker or service provider (and its other related parties), except if the employee is used in an effort to circumvent the provisions of the Variable Interest Entities Subsections of this Subtopic.

b. An employee benefit plan of the decision maker or service provider (and its other related parties), except if the employee benefit plan is used in an effort to circumvent the provisions of the Variable Interest Entities Subsections of this Subtopic.

For purposes of evaluating the conditions in paragraph 810-10-55-37, the quantitative approach described in the definitions of the terms expected losses, expected residual returns, and expected variability is not required and should not be the sole determinant as to whether a reporting entity meets such conditions.

Pending Content (Transition Guidance: ASC 810-10-65-9)

55-37D For purposes of evaluating the conditions in paragraph 810-10-55-37, any variable interest in an entity that is held by a related party of the decision maker or service provider should be considered in the analysis. Specifically, a decision maker or service provider should include its direct variable interests in the entity and its indirect variable interests in the entity held through related parties, considered on a proportionate basis. For example, if a decision maker or service provider owns a 20 percent interest in a related party and that related party owns a 40 percent interest in the entity being evaluated, the decision maker’s or service provider’s interest would be considered equivalent to an 8 percent direct interest in the entity for the purposes of evaluating whether the fees paid to the decision maker(s) or the service provider(s) are not variable interests (assuming that they have no other relationships with the entity). The term related parties in this paragraph refers to all parties as defined in paragraph 810-10-25-43, with the following exceptions:

a. An employee of the decision maker or service provider (and its other related parties), except if the employee is used in an effort to circumvent the provisions of the Variable Interest Entities Subsections of this Subtopic.

b. An employee benefit plan of the decision maker or service provider (and its other related parties), except if the employee benefit plan is used in an effort to circumvent the provisions of the Variable Interest Entities Subsections of this Subtopic.

For purposes of evaluating the conditions in paragraph 810-10-55-37, the quantitative approach described in the definitions of the terms expected losses, expected residual returns, and expected variability is not required and should not be the sole determinant as to whether a reporting entity meets such conditions.

55-38 Fees paid to decision makers or service providers that do not meet all of the conditions in paragraph 810-10-55-37 are variable interests.
The above guidance applies to both decision makers and service providers. The determination of whether a decision maker's fee arrangement is a variable interest has a significant impact on the consolidation conclusion, because if it is determined that a decision maker's fee arrangement is not a variable interest, the decision maker would be acting as a fiduciary for the legal entity. This determination could affect whether the legal entity is a VIE (see Section 5.3.1.1.3.1) and whether the decision maker is required to consolidate the VIE.

Fees paid to a decision maker or service provider do not represent a variable interest if all of the following are met:

1. The fees are “commensurate” under ASC 810-10-55-37(a). See Section 4.4.1.
2. The arrangement is “at market” under ASC 810-10-55-37(d). See Section 4.4.1.
3. The decision maker or service provider does not have any other interests (direct interests, indirect interests through its related parties, or certain interests held by its related parties under common control) in the legal entity that absorb more than an insignificant amount of the potential VIE’s variability (ASC 810-10-55-37(c)). See Section 4.4.2.

ASU 2015-02 amended the application of the criteria in ASC 810-10-55-37(c) to allow a reporting entity to exclude interests held by certain of its related parties (including de facto agents) when evaluating its economic exposure as part of determining whether, on the basis of its relationship with the related party, its decision-making arrangement represents a variable interest.

Specifically, interests held by a decision maker's or service provider's related parties (or de facto agents) that are not under common control are only to be included in the evaluation of whether the decision maker's or service provider's fee arrangement is a variable interest when the decision maker or service provider has a variable interest in the related party. If the decision maker or service provider has a variable interest in the related party, it would include its economic exposure to the legal entity through its related party on a proportionate basis. For example, if a decision maker or service provider owns a 20 percent interest in a related party, and that related party owns a 40 percent interest in the legal entity being evaluated, the decision maker's or service provider's interest would be considered equivalent to an 8 percent direct interest in the legal entity. However, if the decision maker or service provider did not hold the 20 percent interest in its related party, it would not include any of the related party's interest in its evaluation (see Section 4.4.2.3.1).

By contrast, interests held by a decision maker's or service provider's related parties (or de facto agents) that are under common control should be included at their full amounts in the evaluation of whether the decision maker's or service provider's fee arrangement represents a variable interest when (1) the decision maker or service provider has an interest in the related party or (2) the interest is held by the related party in an effort to circumvent consolidation (see Section 4.4.2.3.2).

**Changing Lanes**

In October 2018, the FASB issued ASU 2018-17, which requires all indirect interests held through related parties, regardless of whether they are under common control, to be considered proportionately in the determination of whether a service provider's fee represents a variable interest. See Section 4.4.2.3.2 for further information.
4.4.1 “Commensurate” and “At-Market” Fees

As discussed above, three criteria must be met for a decision maker or service provider to conclude its fee does not represent a variable interest. Specifically, (1) the fees must be “commensurate,” (2) the fees must be “at market,” and (3) the decision maker or service provider must not have any other interests in the legal entity (either directly or indirectly through its related parties, or certain interests held by its related parties under common control). However, if a decision maker or service provider’s fees are determined to represent a variable interest solely because they meet the third criterion, those fees are not included in the evaluation of the economics criterion (see Section 7.3). As a result, the determination of whether a decision maker’s or service provider’s fees are “commensurate” and “at market” is a critical step in both the assessment of whether such fees represent a variable interest and the evaluation of the economics criterion. “Commensurate” and “at market” can be described as follows:

- Fees are “commensurate” (i.e., they are compensation for services provided and are commensurate with the level of effort required to provide those services).
- A service arrangement is “at market” (i.e., it includes only terms, conditions, or amounts that are customarily present in arrangements for similar services negotiated at arm’s length).

The first step in the reporting entity’s assessment of whether its fee arrangement is commensurate and at market is to determine whether other benefits or elements are embedded in the fees. If the fees include compensation for assuming risk of loss in the potential VIE (see Section 4.4.1.1), the fee arrangement is a variable interest. However, other benefits or elements embedded in the fee arrangement that are not compensation for assuming risk of loss would not automatically cause the fee arrangement to be a variable interest and will need to be carefully evaluated.

If there are no other features embedded in the fee arrangement, the decision maker or service provider must consider whether the arrangement includes commensurate fees and at-market terms. At the 2015 AICPA Conference on Current SEC and PCAOB Developments, an SEC staff member, Professional Accounting Fellow Chris Semesky, stated the following:

I would also like to address the evaluation of whether a decision-maker’s fee arrangement is customary and commensurate. [Footnote omitted] This evaluation is done at inception of a service arrangement or upon a reconsideration event, such as the modification of any germane terms, conditions or amounts in the arrangement.

The determination of whether fees are commensurate with the level of service provided often may be determined through a qualitative evaluation of whether an arrangement was negotiated on an arm’s length basis when there are no obligations beyond the services provided to direct the activities of the entity being evaluated for consolidation. This analysis requires a careful consideration of the services to be provided by the decision-maker in relation to the fees.

The evaluation of whether terms, conditions and amounts included in an arrangement are customarily present in arrangements for similar services may be accomplished in ways such as benchmarking the key characteristics of the subject arrangement against other market participants’ arrangements negotiated on an arm’s length basis, or in some instances against other arm’s length arrangements entered into by the decision-maker. There are no bright lines in evaluating whether an arrangement is customary, and reasonable judgment is required in such an evaluation. A decision-maker should carefully consider whether any terms, conditions, or amounts would substantively affect the decision-maker’s role as an agent or service provider to the other variable interest holders in an entity.

Therefore, we believe that the evaluation of whether the fees are commensurate should focus on whether the fee arrangements are negotiated at arm’s length (i.e., between unrelated parties) or have been implicitly accepted by market participants. Most decision-maker or service-provider fee arrangements are negotiated at arm’s length or have been implicitly accepted by market participants when a more than insignificant amount of the investor interests in the potential VIE is held by an
unrelated party or parties (e.g., when an asset manager has marketed a fund to outside investors). In these situations, there is a presumption that the fees will be commensurate (even if the services are not provided by others in the marketplace — see Section 4.4.1.5). To support a conclusion that the arrangement is at market (i.e., customary) a reporting entity would, in addition to demonstrating that negotiations were at arm’s length or there was implicit acceptance by market participants, compare its fee arrangement with other arrangements it negotiated with third parties. Therefore, in these situations, it would typically not be necessary for a reporting entity to compare its fee arrangement to others in the marketplace to support its conclusion that the fee arrangement is commensurate and at market unless the reporting entity has no other internal benchmarks.

However, when fees are not negotiated at arm’s length, or there are other benefits or elements embedded in the fee arrangement, the reporting entity would generally need more evidence to determine whether the fee arrangement is designed in a manner that is inconsistent with the decision maker’s or service provider’s role and whether the fees would therefore not be commensurate or at market.

In this situation, the reporting entity should analyze whether the fee arrangement is similar to those entered into between the decision maker or service provider and unrelated parties, or among parties outside the arrangement being evaluated. As part of this assessment, the reporting entity should consider other interests that were entered into contemporaneously with the fee arrangement (e.g., if in addition to the fee arrangement, the decision maker received an equity interest with a preferential return). While the size of a fee would not, in isolation, prevent a compensation arrangement from meeting the commensurate or at market criterion, a significant discrepancy between the fee arrangement being analyzed and those entered into by third parties with relationships that are similar to the one between the potential VIE and the decision maker or service provider may indicate that the reporting entity’s fee is not commensurate or at market.

In certain circumstances, a decision maker or service provider may waive its fees, or a portion of its fees, for a specified period (e.g., during the startup of a fund). In such situations, the reporting entity should analyze whether the fee arrangement, including the effect of the fee waiver, is similar to an arrangement entered into between the decision maker or service provider and unrelated parties. A fee waiver itself does not preclude a decision maker from concluding that the fee arrangement is commensurate and at market. Rather, the decision maker should consider other fee arrangements the decision maker has entered into, whether it has a policy for waiving fees for similar funds, or whether fee waivers are common in its industry. The reporting entity should carefully consider the facts and circumstances in determining whether fee waivers meet the commensurate and at-market criteria.

**Example 4-20**

Entity A enters into an arrangement with an unrelated party to manage the operations of a potential VIE that was established to hold a single real estate asset for an annual fee of $100,000. The fees and terms of the arrangement are similar to other arrangements A has with other unrelated parties. Because the fee was negotiated at arm’s length with an unrelated party, is consistent with other arrangements with unrelated parties, and there are no other benefits or elements embedded in the fee arrangement, A would exclude its fees when assessing whether it has a variable interest or has satisfied the economics criterion in ASC 810-10-25-38A(b).

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2 In some cases, a legal entity may not have direct outside investors; rather, the investors invest through another legal entity that was formed in conjunction with the legal entity (e.g., a master-feeder structure). In these circumstances, the lack of outside investors would not be an indication that the fees paid (or lack thereof) to the legal entity’s decision maker are not commensurate and at market.
Example 4-21

Entity A enters into an arrangement with an equity method investee (which is a related party) to manage the operations of a potential VIE that was established by the investee to hold a single real estate asset. Entity A will receive an annual fee of $100,000. The amount of the management fee is similar to those in arrangements entered into by A with other unrelated clients for similar arrangements in the nearby geographic area. Although the fee was negotiated with a related party, it is consistent with fees entered into by other parties with similar arrangements, and there are no other benefits or elements embedded in the fee arrangement. Entity A would therefore exclude its fees when assessing whether it has a variable interest or has satisfied the economics criterion in ASC 810-10-25-38A(b).

Example 4-22

Entity A manages an investment fund in exchange for a fixed annual fee equal to 50 basis points of assets under management and a variable fee equal to 20 percent of all returns in excess of a 5 percent internal rate of return (IRR). The investors in the investment fund are unrelated to A and have thus implicitly agreed to the terms and conditions of the fund, including A’s fee. The fee is also consistent with fee arrangements entered into by A with other unrelated parties. The management contract extends over the life of the investment fund and is cancelable only in the case of gross negligence, fraud, or other illegal acts by A. In this instance, A is significantly participating in the returns of the fund through its fee arrangement. However, since the fee arrangement was accepted by unrelated investors in the investment fund, and is consistent with other arrangements with unrelated parties, the fee arrangement is presumed to be commensurate and at market. Accordingly, as long as other benefits or elements are not embedded in the fee arrangement (e.g., see Example 4-23), A would exclude its fee when assessing whether it has a variable interest or has satisfied the economics criterion in ASC 810-10-25-38A(b).

Example 4-23

Assume the same facts as in Example 4-22, except that because it received an amount significantly below fair market value for assets that it transferred at inception of the investment fund, A receives for its management services a fixed annual fee equal to 50 basis points of assets under management and a variable fee equal to 80 percent of all returns in excess of a 5 percent IRR. In this instance, although the fee structure was accepted by unrelated parties that invested in the investment fund, the fees are not commensurate because there is another benefit or element embedded in the decision-maker contract. Entity A would therefore conclude that the fee arrangement is a variable interest and would include the entire fee in its assessment of whether it has satisfied the economics criterion in ASC 810-10-25-38A(b).

4.4.1.1 Compensation Received Related to Risk Exposure

If the fee arrangement is designed to expose a reporting entity to risk of loss in the potential VIE (e.g., a guarantee embedded in the fee arrangement), the fees will be considered a variable interest and included in the reporting entity’s evaluation under the economics criterion in ASC 810-10-25-38A(b). In paragraph BC43 of ASU 2015-02, the FASB explained that a fee arrangement that exposes a reporting entity to risk of loss in a potential VIE should never be eligible for exclusion from the evaluation of whether it (1) is a variable interest or (2) satisfies the economics criterion. This serves as a safeguard to ensure that if an arrangement is structured as a means to absorb risk of loss that the legal entity was designed to pass on to its variable interest holders, the arrangement will be included in the consolidation analysis. Therefore, even if such fees are otherwise commensurate and at market (see Section 4.4.1), they would not be eligible for (1) inclusion in the fee-arrangement evaluation under ASC 810-10-55-37 or (2) exclusion from the primary-beneficiary evaluation. A reporting entity’s expectation related to the magnitude of losses that it will incur from a fee arrangement that exposes the reporting entity to a risk of loss in a potential VIE does not factor into the evaluation. That is, a reporting entity cannot apply the guidance in ASC 810-10-55-37 on evaluating fee arrangements on the basis of its
belief that the expected losses absorbed by the fee arrangement will be insignificant relative to the total expected losses of the potential VIE.

A reporting entity should carefully consider the design of the potential VIE to determine whether the related exposure that the fee arrangement absorbs is a risk that the legal entity was designed to pass on to its variable interest holders. For example, the fee arrangement may be substantially a fee-for-service contract and have certain protections that are customary and standard, but it does not expose the decision maker or service provider to any of the primary risks of the potential VIE. In this case, the fees received are not designed as compensation for exposure to risk of loss in the potential VIE. While fees received as compensation for providing loss protection to the legal entity are typically easy to identify, reporting entities must carefully consider all the facts and circumstances associated with fee structures that are designed to reduce or eliminate losses that would otherwise accrue to the holders of the legal entity’s variable interests. In accordance with ASC 810-10-55-37C(d), a reporting entity should also consider obligations or arrangements that implicitly protect holders of other interests from suffering losses in a potential VIE.

**Example 4-24**

Entity A manages an investment fund in exchange for a fixed annual fee equal to 50 basis points of assets under management and a variable fee equal to 20 percent of all returns in excess of an 8 percent IRR. The investors in the investment fund are unrelated to A, having implicitly agreed to the terms and conditions of the fund, including A’s fee. The fees are commensurate and at market, and A (including its related parties under common control) does not have any other interests in the entity.

Although A’s fee is variable, the variability allows the service provider to participate in the profits of the fund but does not expose A to the risk of losses of the fund. Therefore, A would not have a variable interest because the fee arrangement does not expose A to the risk of loss in the potential VIE.

**Example 4-25**

Entity A enters into an arrangement with an unrelated party to manage the operations of a VIE with a single real estate asset for an annual fee of $120,000. However, the fee arrangement also contains a provision that requires A to pay $50,000 to the VIE for each month that the real estate asset is less than 70 percent occupied. Accordingly, if the real estate asset had occupancy of less than 70 percent for the full year, A would be required to pay the VIE $600,000. While the fee appears to have been negotiated at arm’s length with an unrelated party, A has effectively protected the holders of other interests in the VIE from suffering losses in the VIE. Therefore, A would have a variable interest, and the entire fee, as well as the maximum exposure to loss, must be included in A’s evaluation of whether it satisfies the economics criterion in ASC 810-10-25-38A(b) (see Section 7.3.4.3).
Example 4-26

Entity A transfers loans into a securitization trust and retains the right to unilaterally perform the servicing function, which represents the activities that most significantly affect the economic performance of the trust. Entity A receives annually 50 basis points of the unpaid principal balance each period for performing the services, and this amount is determined to be commensurate and at market. The transfer and servicing agreement specifies that A must:

- Repurchase any loan as a result of identified origination defects, errors in servicing a loan, or other violations of standard representations and warranties.³
- Advance principal, interest, taxes, and insurance to the investors of the trust. Entity A is permitted to collect any advance made through future cash flows from the assets of the trust. Further, A is only required to make an advance to the extent that it believes that the future cash flows will be sufficient to pay back the advances.

The investors of the trust have no recourse to A other than the above obligations. Although the obligations expose A to certain risks of loss, those risks are not the risks the trust was designed to pass on to its variable interest holders. Rather, the risks of the trust are the underlying credit of the financial assets transferred. The standard representations and warranties protect the investors from risks that the financial assets are not what they are purported to represent; the advances represent ongoing contractual obligations to service the financial assets and are only made if the servicer expects to collect on the advances (i.e., is not designed to absorb losses of the variable interest holders). Therefore, the fee arrangement is not compensation for exposure to the risk of loss in the potential VIE,⁴ and the reporting entity would be eligible to exclude the fees from its evaluation of whether (1) the fees represent a variable interest and (2) the economics criterion in ASC 810-10-25-38A has been satisfied.

Example 4-26A

Entity A transfers loans into a securitization trust and retains the right to unilaterally perform the servicing function, which represents the activities that most significantly affect the economic performance of the trust. Entity A receives annually 50 basis points of the unpaid principal balance each period for performing the services, and this amount is determined to be commensurate and at market. The servicing agreement specifies that A has the option to repurchase any loan in the securitization trust that is modified to reduce the interest rate, reduce the principal amount, or extend the contractual term. The repurchase price is equal to the outstanding principal amount plus any accrued and unpaid interest and fees. Modifications to loans within the trust are allowed only in response to a deterioration in the borrower's creditworthiness (i.e., to maximize expected cash flows on the loans). Assume that the securitization trust is a VIE that was designed to pass credit risk on to its variable interest holders.

Although A has an option, which represents an explicit right as opposed to an explicit obligation, to repurchase the loans that are modified, through past practice A has established a history of always purchasing any modified loans even when the purchase price is in excess of the value of the loans. Investors in the securitization trust also have an expectation, on the basis of this history, that A will continue to repurchase modified loans. If A were to stop purchasing modified loans, its ability to execute future similar securitization trusts at favorable pricing would be negatively affected.

In this example, there is an implicit agreement that A will protect other variable interest holders from potential credit losses; therefore, the servicing arrangement is a variable interest. Entity A reaches this conclusion because (1) the repurchase price, by design, could expose it to losses since the fair value of modified loans would generally not be expected to equal or exceed the principal amount outstanding, plus accrued and unpaid interest and fees, and (2) on the basis of past practice and other available evidence, A expects to continue to absorb potential credit losses that would otherwise be absorbed by the third-party variable interest holders.

³ Standard representations and warranties include those asserting that the financial asset being transferred is what it is purported to be on the transfer date. Examples include representations and warranties about (1) the characteristics, nature, and quality of the underlying financial asset, including characteristics of the underlying borrower and the type and nature of the collateral securing the underlying financial asset; (2) the quality, accuracy, and delivery of documentation related to the transfer and the underlying financial asset; and (3) the accuracy of the transferor’s representations relative to the underlying financial asset.

⁴ This conclusion is also consistent with permitted recourse in the evaluation of whether the transfer of a portion of a financial asset meets the definition of a participating interest in ASC 860-10-40-6A(c)(4).
4.4.1.2 Fees in Excess of Adequate Compensation — Impact on Commensurate and At-Market Determinations

It is common for servicers in securitizations and other loan transfers to receive more than “adequate compensation” for their servicing of the financial assets. ASC 860-50-20 defines adequate compensation as follows:

The amount of benefits of servicing that would fairly compensate a substitute servicer should one be required, which includes the profit that would be demanded in the marketplace. It is the amount demanded by the marketplace to perform the specific type of servicing. Adequate compensation is determined by the marketplace; it does not vary according to the specific servicing costs of the servicer.

Under ASC 860-50, if a servicer is entitled to compensation that is in excess of adequate, a servicing asset must be recorded. The servicing asset represents the future expected value of performance under the servicing arrangement in excess of what the servicer would pay an unrelated party to perform the servicing on its behalf. Depending on the type of assets being serviced, the fees may be significantly higher than adequate compensation.

The recognition of a servicing asset is not an automatic indicator that the fees are not commensurate or at market. That is, although adequate compensation would be considered commensurate and at market because the fee is, by definition, consistent with “the amount demanded by the marketplace to perform the specific type of servicing,” since unrelated market participants determine the service-provider fee (e.g., servicers for government-sponsored entity trusts generally receive 25 basis points), an amount in excess of adequate compensation may still be considered commensurate and at market. The reporting entity should evaluate the arrangement, including whether (1) it was negotiated at arm’s length, (2) there are more than insignificant unrelated investors in the securitization, (3) the arrangement is consistent with other arrangements entered into with unrelated parties or other arrangements in the marketplace, and (4) there are other benefits or elements embedded in the fee arrangement unrelated to the services provided.

Conversely, if a servicer recognized a servicing liability at inception (i.e., the fees are below adequate compensation), those fees generally would not be commensurate or at market and, therefore, would be deemed a variable interest and included in the analysis of whether it has satisfied the economics criterion in ASC 810-10-25-38A(b).

Example 4-27

Entity A transfers loans into a securitization trust and retains the right to unilaterally perform the servicing function, which consists of performing the activities that most significantly affect the economic performance of the trust. The beneficial interests of the trust are held entirely by unrelated parties. Entity A receives annually 50 basis points of the unpaid principal balance each period for performing the services, which is consistent with the amount generally retained for servicing similar assets both internal to A for unrelated investors and other arrangements in the marketplace. Entity A determines that adequate compensation is 30 basis points and, therefore, recognizes a servicing asset upon transfer. However, A determines that there were more than insignificant unrelated investors in the trust and that there are no other benefits or elements embedded in the fee arrangement unrelated to the services provided. Therefore, despite recognizing a servicing asset, A would conclude that the fee arrangement is commensurate and at market.
Example 4-28

Assume the same facts as in Example 4-27, except that A receives annually 200 basis points of the unpaid principal balance each period for performing the services, which is well in excess of what A charges in other securitization trusts. Entity A negotiated the higher servicing fee in return for lower proceeds on the transfer. In this case, although the fee arrangement was negotiated at arm’s length, and unrelated parties accepted the fee structure, A would determine that its fees are not commensurate and at market because additional returns have been embedded in the fee arrangement. Therefore, A would conclude that the fee arrangement is a variable interest and would include the entire fee in assessing whether it has satisfied the economics criterion in ASC 810-10-25-38A(b).

4.4.1.3 Fee Arrangements That Are Designed to Transfer the Residual Risks and Rewards of Ownership

A fee arrangement that is designed to transfer substantially all of the residual risks and rewards of ownership to the decision maker of a potential VIE would not be considered commensurate and at market. Case L in ASC 810-10-55-205Z through 55-205AI illustrates that this type of arrangement is a variable interest and would not be considered a fee that is excluded from the consideration under the economics criterion in ASC 810-10-25-38A(b). In Case L, the primary purpose of the legal entity was to bypass foreign investment restrictions and enable foreign investors to participate indirectly in restricted sectors through a series of contractual arrangements that gave the investor (Company A) all the net income of the legal entity.

We are aware of similar arrangements that transfer substantially all the risks and rewards of ownership to a reporting entity through contractual arrangements. Since substantially all the economics of the potential VIE, by design, are transferred to the reporting entity, the arrangement cannot be considered commensurate and at market, regardless of whether there are comparable arrangements in the marketplace. This conclusion would also apply to arrangements outside foreign jurisdictions, such as physician practice management entities in which an investor purchases the rights to operate and retain all or substantially all the residual risks and rewards of a legal entity.

These considerations are not limited to fee arrangements that absorb substantially all of a potential VIE’s economics. A distinguishing factor in many of these contractual arrangements is that they require the service provider/investor to make a significant investment to gain the rights to the future economics of the legal entity. Accordingly, reporting entities should carefully consider fee arrangements in which a significant amount of the economics of a legal entity are being redistributed to a reporting entity through a contract that requires a significant investment to gain those rights. Many of these arrangements have an obligation to fund losses and would not satisfy the condition in ASC 810-10-55-37C; therefore, the fees would automatically be variable interests and would not be evaluated to determine whether substantially all the risks and rewards of ownership are through a contractual arrangement. That is, since the fee arrangement includes an obligation to absorb losses, the fees are variable interests and no assessment of whether the fees are commensurate or at market is required.
Example 4-29

Entity A wishes to expand its presence into a foreign jurisdiction that precludes foreign ownership of companies in A’s industry. As a result, A enters into a contractual arrangement with the sole shareholder of Entity B, an unrelated party, under which A acquires the shareholder’s rights to all dividends paid from B in exchange for an up-front cash payment. Further, A enters into a management services agreement with B that gives A the ability to make all significant operating and capital decisions for B. The management services agreement has an initial five-year term, is unilaterally extendable by A for an unlimited amount of successive five-year terms, and requires that B pay to A 100 percent of its after-tax income in the form of a management fee. (Alternatively, the management services agreement may give A the ability to unilaterally determine the amount of the fee payable in any given year.) In this instance, B’s shareholder has effectively surrendered its control and right to participate in the risks and rewards of B to A, thus becoming a nominee shareholder. Entity A therefore has a variable interest and is required to include the fee in its evaluation of whether it has met the economics criterion in ASC 810-10-25-38A(b).

4.4.1.4 Analyzing Decision-Making Rights Embedded in a General Partner Interest

A general partner’s ability to make decisions for a partnership is typically embedded in an equity interest. That is, the general partner typically invests a stated amount in the partnership in exchange for (1) an investment return on the stated amount (like the limited partners) and (2) additional returns designed to compensate it for its general partner services. An equity interest that gives the general partner decision-making rights is substantively a multiple-element arrangement with an equity component and an embedded fee component. Accordingly, the general partner should separate the stated investment and fee arrangement and determine whether the fee arrangement represents a variable interest under ASC 810-10-55-37.

Connecting the Dots

Before adoption of the FASB’s new revenue standard (ASC 606), general partner investors that did not have a controlling financial interest in the underlying partnership generally accounted for their general partner interest, excluding the disproportionate allocation of profits, by using the equity method of accounting in ASC 323. For the capital-allocation-based arrangement portion of their general partner investments, generally investors applied EITF Topic D-96, which specifies two acceptable approaches to accounting for the receipt of fees for performance-based fee arrangements. However, some investors may have determined that the capital-allocation-based arrangement portion of their general partner investments was within the scope of ASC 323.

As a result of the new revenue standard, questions have emerged regarding whether these capital-allocation-based arrangements are within the scope of ASC 606 or whether they should be accounted for under other GAAP (particularly ASC 323). In certain arrangements, a general partner may be able to demonstrate that its capital-allocation-based arrangements that involve an equity interest are financial instruments within the scope of other GAAP, particularly ASC 323. In such cases, these arrangements would qualify for the scope exception under ASC 606-10-15-2(c)(3).

However, we do not believe that a general partner’s conclusion regarding the accounting for its fee arrangement affects the analysis under ASC 810. That is, it remains appropriate to treat the stated investment and the fee arrangement separately in the determination of whether the general partner has a variable interest through the fee arrangement. We understand that this interpretation is consistent with the SEC staff’s view. For additional information about ASC 606, see Section 3.2.6 of Deloitte’s A Roadmap to Applying the New Revenue Recognition Standard.

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Footnote 5: It is assumed throughout this Roadmap that the reporting entity has adopted the new revenue standard.
This scenario is illustrated in Case J in ASC 810-10-55-205L through 55-205V, in which a fund manager with a general partner interest applied ASC 810-10-55-37 to analyze its general partner interests to determine whether its fees are a variable interest. Further, in our discussions with the FASB staff, the staff confirmed that fee components should be evaluated separately when they are embedded in a general partner equity interest. However, like other fee arrangements that are designed to compensate the decision maker or service provider for assuming risk of loss in the potential VIE (see Section 4.4.1.1), the embedded fee arrangement would automatically be considered a variable interest (i.e., would not be permitted to apply ASC 810-10-55-37) and would be included in the primary-beneficiary evaluation under ASC 810-10-25-38A if the embedded fee component provides loss protection to other interest holders.

In determining whether the general partner is using its decision-making rights in a fiduciary capacity (i.e., the decision-making rights are not considered a variable interest because they meet all the conditions in ASC 810-10-55-37), the general partner should consider the amount it invested for the equity component of its general partner interest and any other interests that it holds (e.g., limited partner interests or guarantees), including indirect interests held through its related parties and certain interests held by its related parties under common control, to assess its economic exposure to the partnership (ASC 810-10-55-37(c)) (see Section 4.4.2). The general partner should also analyze the fees to determine whether they are commensurate and at market (see Section 4.4.1).

If the general partner determines that it is acting in a fiduciary capacity, its fee arrangement would not satisfy the “power” criterion in ASC 810-10-25-38A(a) and the general partner therefore would not consolidate the VIE. However, a substantive equity component will qualify as a variable interest (as would an equity interest held by the limited partners). Accordingly, even if the general partner concludes that it is not required to consolidate a partnership, the general partner would need to consider whether it should provide the VIE disclosures (see Section 11.2).

**Example 4-30**

Entity A is the general partner of Limited Partnership B (a VIE). Entity A has a 5 percent general partner interest in B that provides it with (1) risks and rewards that are similar to those of the limited partners and (2) the right to receive a performance-based fee. The performance fee is compensation for A's management of B's operations and is commensurate and at market. Further, the 5 percent general partner interest (exclusive of the fee component) does not receive any benefits or risks that are disproportionate to those of the other investors. Entity A has also provided a separate guarantee to the partnership related to a remote event. Accordingly, while it is not expected that the guarantee will absorb more than an insignificant amount of the VIE's expected losses (ASC 810-10-55-37(c)), the guarantee could potentially be significant to the VIE (ASC 810-10-25-38A(b)) (without taking probability into account).

The embedded fee arrangement would meet all three criteria in ASC 810-10-55-37 and would therefore not be considered a variable interest (A would conclude that it is acting as a fiduciary). Specifically, in evaluating its economic exposure as part of its assessment of whether the embedded fee arrangement is a variable interest, A has determined that its 5 percent general partner equity interest and guarantee do not collectively absorb more than an insignificant amount of B's expected variability. However, the general partner equity interest and guarantee would be considered variable interests, and A must provide the required VIE disclosures. On the other hand, if A had a general partner equity interest of 15 percent (which absorbs more than an insignificant amount of B's expected variability), A's fee arrangement would be a variable interest because it would not satisfy the criterion in ASC 810-10-55-37(c), and A would meet both of the primary-beneficiary criteria in ASC 810-10-25-38A.
**4.4.1.5 Absence of Similar Arrangements**

At times, no comparable fee arrangements will be available (internally or in the marketplace) for a reporting entity to use in assessing whether its fee arrangement is commensurate and at market. As stated in ASC 810-10-55-37B, a fee would not presumptively fail to be commensurate and at market in the absence of similar service arrangements if either of the following apply:

- “The fee arrangement relates to a unique or new service.”
- “The fee arrangement reflects a change in what is considered customary for the services.”

In such situations, the determination of whether a fee arrangement is commensurate and at market will be based on the reporting entity’s facts and circumstances. Questions to consider include, but are not limited to, the following:

- Was the service arrangement negotiated at arm’s length, or have the terms been implicitly accepted by unrelated market participants (i.e., a more than insignificant amount of the investor interests in the potential VIE is held by an unrelated party or parties)?
- Are there other benefits or elements embedded in the fee arrangement?
- If the services are unique because they are incremental (or reductive) to other internal arrangements with unrelated third parties or marketplace arrangements, does the increase (or decrease) in fees adjust appropriately for the incremental (or reductive) services?
- How was the pricing determined by the service provider (e.g., does it take into account the expected cost plus a reasonable profit margin for the risk of providing the services)?

**4.4.2 Analyzing Other Interests of the Decision Maker or Service Provider**

The FASB retained the requirement for reporting entities to consider whether a decision maker or service provider has any other interests (direct, implicit, indirect interests through its related parties, or certain interests held by its related parties under common control) in the legal entity that absorb more than an insignificant amount of the potential VIE’s variability. The FASB reasoned that if such interests are held by the decision maker or service provider (or certain of its related parties), the decision maker or service provider may be acting, at least in part, as a principal rather than a fiduciary in providing its services. In performing this analysis, the decision maker and service provider should therefore consider the design of the legal entity and all contractual or noncontractual provisions.

**4.4.2.1 Meaning of “Insignificant” in the Analysis of Fees Paid to a Decision Maker or Service Provider**

ASC 810-10 does not define the term “insignificant” as used in ASC 810-10-55-37(c). However, as a general guideline, if the expected losses absorbed or expected residual returns received through variable interests (other than the fee arrangement) in the potential VIE exceed, either individually or in the aggregate, 10 percent or more of the expected losses or expected residual returns of the potential VIE, the condition in ASC 810-10-55-37(c) is not met, and the decision-maker or service-provider fee would be considered a variable interest. However, because of the subjective nature of the calculation of expected losses and expected residual returns, in some fact patterns (e.g., when the variable interest holders do not share in losses and returns on a proportional basis), 10 percent should not be viewed as a bright-line threshold or safe harbor. In light of these considerations, the reporting entity will need to apply professional judgment and assess the nature of its involvement with the potential VIE.
The analysis under ASC 810-10-55-37(c) deals with the expected outcome of the potential VIE. Therefore, when analyzing a decision-maker or service-provider fee under this criterion, a reporting entity would identify and weigh the probability of the various possible outcomes in determining the expected losses and expected residual returns of the potential VIE. However, the reporting entity may not be required to prepare a detailed quantitative analysis to reach a conclusion under ASC 810-10-55-37(c). For example, if a decision maker holds 100 percent of the residual interest in a legal entity (and the residual interest is substantive), a reporting entity may qualitatively conclude that holding all of a substantive residual interest would represent more than an insignificant amount of the legal entity’s expected losses or expected residual returns. Conversely, if a decision maker holds less than 10 percent of the residual interest in a legal entity, the reporting entity may qualitatively conclude that holding less than 10 percent of the residual interest would not represent more than an insignificant amount of the legal entity’s expected losses or expected residual returns.

Although the consideration of the probabilities of various outcomes is important in the determination of whether a decision-maker or service-provider fee is a variable interest under ASC 810-10-55-37(c), such probabilities generally may not be considered in the determination of whether the reporting entity meets the economics criterion under ASC 810-10-25-38A(b). That is, while the “significant” threshold is used in both assessments, the evaluation of a decision maker’s economic exposure under ASC 810-10-25-38A(b) focuses on whether the reporting entity’s economic exposure could be more than insignificant. Therefore, if the condition in ASC 810-10-55-37(c) is not met as a result of a direct or indirect interest held by the decision maker, it would be unusual for the decision maker to not meet the economics criterion in ASC 810-10-25-38A(b). See Section 7.3.2 for more information about the economics criterion.

4.4.2.2 Performance-Based Fee Arrangements

Certain fee arrangements may allow asset managers to receive performance-based fees (i.e., calculated on the basis of the performance of the underlying assets being managed). The fee arrangements may be complex as a result of high-water marks or performance hurdles, and external factors such as a market index may be used to evaluate the performance of the underlying assets. A performance fee may also be subject to (1) lock-up provisions, under which the fees will only be paid to the investment manager once the underlying investments have been sold, or (2) clawback provisions, under which the manager is required to return the fee for underperformance in future periods.

To align the interests of an asset manager with those of investors, asset managers typically structure their fee arrangements to include participation in the legal entity’s profits (along with the equity investors). Such fee arrangements should be assessed under ASC 810-10-55-37 to ascertain whether they represent variable interests rather than evaluated as equity instruments. In addition, lock-up provisions that affect the timing of when the asset manager will receive these fees do not cause the fees to be considered equity interests in the legal entity being evaluated.

While lock-up provisions may affect the timing or receipt of fees received under the arrangement, they do not change the nature of the fee arrangement to that of an equity investment. That is, although the amount allocated to the asset manager is subject to future reversal if performance of the legal entity declines, a performance-based fee subject to a lock-up provision should still be regarded as a fee arrangement. The FASB’s intention in amending the guidance on fee arrangements was to distinguish between fee arrangements that allow the recipient to participate in the variability in the economic performance of the legal entity and those that expose the recipient to a risk of loss. As explained in paragraph BC42 of ASU 2015-02, the FASB determined that a fee arrangement that can result in the nonreceipt of fees exposes the recipient to an opportunity cost but not to a risk of loss (i.e., the recipient will never have to “write a check”). A lock-up provision exposes the recipient to such an opportunity.
cost but not to a risk of loss; accordingly, the presence of a lock-up provision does not affect the ability of a service provider or decision maker to assess the fee arrangement under the requirements in ASC 810-10-55-37.

Further, a performance-based fee that has been distributed to the asset manager but is subject to future clawback would also not be treated as an “other interest” (e.g., equity interest or a guarantee). That is, although the asset manager may be required to refund the legal entity for the amount received, the purpose and design of the arrangement is no different from other performance-based fee arrangements. In other words, over the life of the legal entity, the fee arrangement only exposes the asset manager to opportunity cost (i.e., not earning the performance-based fee), not to losses of the legal entity. However, a requirement that the asset manager refund an amount to the legal entity that is in excess of the performance fees received would expose the asset manager to the risk of losses of the legal entity and therefore would be considered a guarantee.

Once the fee crystallizes (e.g., because the profits on the underlying investments have been realized), there may be a period before which the asset manager is entitled to withdraw its fees. In such circumstances, that portion of the arrangement would no longer be treated as a fee arrangement but rather like all other liabilities of the legal entity. However, the liability would typically not subject the asset manager to a more than insignificant amount of the legal entity's variability because the amounts payable are short term, fixed in amount, and not subordinate to other liabilities of the legal entity, and the probability of a credit-related event that would prevent their payment is often remote.

However, if the asset manager receives its performance-based fee in the form of additional equity interests, or invests the performance-based fees it received back into the legal entity as an additional equity investment, its investment would represent an other interest that would need to be included in the evaluation of whether (1) the fees paid to the asset manager represent a variable interest in the legal entity (a reconsideration event), (2) the reporting entity is the primary beneficiary of the VIE, and (3) the reporting entity is required to provide the VIE-related disclosures (see Section 11.2).

## 4.4.2.3 Impact of Related-Party Relationships on Identification of Variable Interests for a Decision Maker or Service Provider

In its evaluation of the conditions in ASC 810-10-55-37(c), a decision maker or service provider must consider (in addition to its direct other interests) interests held by certain of its related parties. An exception is provided for any interests held by an employee or employee benefit plan of the decision maker or service provider unless the employee or employee benefit plan is used in an effort to circumvent the provisions of the VIE model in ASC 810-10 (see Sections 4.4.2.3.5 and 4.4.2.3.6).

### 4.4.2.3.1 Interests Held by Related Parties That Are Not Under Common Control

Interests held by a decision maker's or service provider's related parties (or de facto agents) that are not under common control would only be included in the evaluation of whether the decision maker's or service provider's fee arrangement is a variable interest when the decision maker or service provider has a variable interest in the related party. If the decision maker or service provider has a variable interest in the related party, it would include its economic exposure to the legal entity through its related party on a proportionate basis.
Example 4-31

A collateral manager owns a 20 percent interest in a related party that is not under common control, and the related party owns 40 percent of the residual tranche of the CFE being evaluated. In this case, the collateral manager's interest would be considered equivalent to an 8 percent direct interest in the residual tranche of the CFE. Therefore, in addition to considering its own direct interest (if any), the collateral manager should include its 8 percent indirect interest when assessing whether its fee arrangement is a variable interest in the CFE and, if so, whether the collateral manager is the primary beneficiary of the CFE. However, if the collateral manager did not hold the 20 percent interest in its related party, it would not include any of the related party's interest in either evaluation.

4.4.2.3.2 Interests Held by Related Parties That Are Under Common Control

The guidance on when the decision maker should consider interests held by related parties under common control has been difficult to interpret. Some initially interpreted it to generally require a decision maker to include interests held by related parties under common control regardless of whether the decision maker held an interest in that related party. However, at the 2015 AICPA Conference on Current SEC and PCAOB Developments, Chris Semesky provided the following comments:

For purposes of illustration consider an entity that has four unrelated investors with equal ownership interests, and a manager that is under common control with one of the investors. The manager has no direct or indirect interests in the entity other than through its management fee, and has the power to direct the activities of the entity that most significantly impact its economic performance.

In this simple example, if the manager's fee would otherwise not meet the criteria to be considered a variable interest, the fact that an investor under common control with the manager has a variable interest that would absorb more than an insignificant amount of variability would not by itself cause the manager's fee to be considered a variable interest. The guidance to consider interests held by related parties when evaluating whether a fee is a variable interest specifically refers to instances where a decision-maker has an indirect economic interest in the entity being evaluated for consolidation. [Footnote omitted] However, in the instance where a controlling party in a common control group designs an entity in a way to separate power from economics for the purpose of avoiding consolidation in the separate company financial statements of a decision-maker, OCA has viewed such separation to be non-substantive.

In my example, if the manager determines that its fee is not a variable interest the amendments in ASU 2015-02 are not intended to subject the manager to potential consolidation of the entity. In other words, a decision-maker would not be required to consolidate through application of the related party tiebreakers once it determines that it does not have a variable interest in the entity.

Therefore, the decision maker should include variable interests in the legal entity held by its related parties under common control (see Sections 2.11 and 4.4.2.3.3 for the definition of common control) as part of its economic exposure in its evaluation of its fee arrangement (ASC 810-10-55-37(c)) as follows:

- If the decision maker has an interest in its related party under common control (e.g., the decision maker owns 15 percent of the equity interest of the related party), the related party's interest should be considered the equivalent of a direct interest held by the decision maker (i.e., the entire interest, rather than a proportionate amount).

- If the decision maker does not hold an interest in the related party under common control (e.g., the related party is a sister company with no cross-ownership interest), the related party's interest would be excluded unless the interest was held by the related party in an effort to circumvent consolidation of the legal entity in the separate financial statements of one of the related parties under common control.
This view is consistent with ASC 810-10-55-37D, which states, in part, that in the evaluation of “the conditions in paragraph 810-10-55-37, any interest in an entity that is held by a related party of the decision maker or service provider should be considered in the analysis” (emphasis added). Further, paragraph BC69 of ASU 2015-02 states that the “basis for this decision is that a parent may move or attribute power to one entity in the related party group and variable interests to other entities in the related party group in an effort to avoid consolidation.”

**Changing Lanes**

In October 2018, the FASB issued ASU 2018-17 to align the guidance in ASC 810 on how interests held by related parties are considered in the assessment of whether a decision maker’s fee is a variable interest, regardless of whether the related parties are under common control. ASC 810-10-55-37D currently requires indirect interests held by related parties under common control to be considered in their entirety in the evaluation of whether a decision maker’s fee arrangement is a variable interest under ASC 810-10-55-37(c). ASU 2018-17 amends ASC 810-10-55-37D so that indirect interests held by related parties under common control are only considered on a proportionate basis in the variable interest analysis. This amendment also aligns the evaluation of indirect interests held by related parties under common control in the variable interest evaluation with the primary-beneficiary analysis, as amended by ASU 2016-17. Therefore, under ASU 2018-17, it is less likely that a decision maker would be required to apply the VIE model because fewer fee arrangements would qualify as variable interests.

The changes made by ASU 2018-17 do not affect interests held through a subsidiary since such interests should be treated as direct interests of the consolidated group in a consolidation assessment. The guidance is effective for public business entities in periods beginning after December 15, 2019, and for private entities in periods beginning after December 15, 2020. Early adoption is permitted. For more information, see Deloitte’s November 19, 2018, *Heads Up* on ASU 2018-17.

A reporting entity might be able to conclude that an interest held by its related party under common control was not provided to the related party in an effort to circumvent consolidation of the legal entity when, for example, (1) a founder and CEO of an asset manager invests his or her own money in a potential VIE directly or through personal family trusts or (2) a parent entity with a consolidated asset manager and a separate consolidated subsidiary actively trades in and out of funds but does not, by design, hold seed capital or long-term interests in a fund. The legal entity’s design would rarely be used in either of these circumstances to circumvent the consolidation provisions. However, the same conclusion could not be reached by a regulated financial institution that transfers its beneficial interests in a securitization structure that it sponsors to an entity under common control to avoid consolidation of the securitization entity in its stand-alone financial statements. Accordingly, facts and circumstances should always be carefully considered.
**Example 4-32**

Subsidiary A and Subsidiary B are under common control but do not have ownership interests in each other. Subsidiary A is the general partner (decision maker) for Partnership C, but does not have any other interests in C. Subsidiary B owns 30 percent of C's limited partner interests. The partnership is considered a VIE.

In this example, on the basis of an analysis of the specific facts and circumstances, A would conclude that its fee arrangement is not a variable interest as long as C has not been designed to circumvent consolidation by A or B. Subsidiary A itself does not have a significant interest in the partnership. In addition, although B owns 30 percent of the equity of C, A would not consider B's 30 percent interest when it evaluates whether A meets the condition in ASC 810-10-55-37(c). Accordingly, if the fees are commensurate and at market, the fee arrangement would not be a variable interest.

**4.4.2.3.3 What Is Meant by “Common Control”**

Entities under common control are limited to subsidiaries of a common parent as well as a subsidiary and its parent, as indicated in paragraph BC69 of ASU 2015-02. The diagram in Example 4-33 below illustrates this relationship.
Example 4-33 (continued)

Entity R has a wholly owned, consolidated asset management subsidiary, Subsidiary A. Subsidiary A is the 1 percent general partner of the Fund. Subsidiary A's general partner interest gives A decision-making rights over the Fund, and in exchange for performing its services, A is entitled to receive a base management fee and a performance-based fee (or carried interest) equal to 20 percent of all returns in excess of a specified threshold. These fees are commensurate and at market (see Section 4.4.1). Entity R also has a 1 percent general partner interest in Co-Investment Fund E. Entity R has the power through its general partner interest to direct all the significant activities of E and cannot be removed without cause. However, R does not have an obligation to absorb losses of E or a right to receive benefits from E that could potentially be significant to E. Therefore, R does not consolidate E. Because R does not consolidate E, a parent-subsidiary relationship does not exist between R and E, and thus E and A are not considered related parties under common control.

4.4.2.3.4 Entities Under Common Control of an Individual

In the determination of common control, an individual can be considered a parent. The parent does not need to be a separate legal entity for a parent/subsidiary relationship to exist. That is, an individual that possesses a controlling financial interest may be identified as a parent. The ASC master glossary defines “parent” as an “entity that has a controlling financial interest in one or more subsidiaries.” In addition, given the FASB’s objectives, as described in paragraph BC69 of ASU 2015-02, regarding identification of related parties under common control in ASC 810-10-25-42, ASC 810-10-25-44A, and ASC 810-10-55-37D, the definition of a parent should include any interest holder that has a controlling financial interest in a subsidiary.

In some instances, two or more reporting entities may have a high degree of common ownership, which would not typically result in a conclusion that the reporting entities are under common control. See Example 8-4.

4.4.2.3.5 Employees and Employee Benefit Plans

ASC 810-10 generally requires indirect economic interests to be included in a reporting entity’s assessment on a proportionate basis. However, ASC 810-10-55-37D specifies certain situations in which holdings of employees or employee benefit plans may be excluded from a reporting entity’s analysis of its involvement with a potential VIE under ASC 810-10-55-37(c) unless the interests are being used to circumvent the provisions of the VIE model.

Note that this exception is limited to the evaluation of the fee arrangement under ASC 810-10-55-37. A reporting entity’s economic exposure through an interest held by an employee or an employee benefit plan are included (either entirely or on a proportionate basis) in a reporting entity’s assessment of whether it is the primary beneficiary of a VIE (see Section 7.3).

Although this exclusion is limited to the application of ASC 810-10-55-37, its practical effect is to reduce instances in which a reporting entity may be identified as the primary beneficiary of a VIE. This is because in the absence of other direct or indirect holdings in a VIE, a fee paid to a decision maker would typically not be identified as a variable interest in a VIE unless the fee is not commensurate and at market (see Section 4.4.1). As a result of excluding these interests in the application of ASC 810-10-55-37, there will be fewer instances in which a fee paid to a decision maker is identified as a variable interest. Accordingly, in these instances, the fee recipient is considered to be acting in a fiduciary capacity and therefore lacks the power criterion in ASC 810-10-25-38A(a) of a primary beneficiary.
Example 4-34

Entity A establishes an investment fund, which it offers to third-party investors. Entity A may only be removed as the manager by a two-thirds vote of the fund's shareholders. In exchange for providing its services, A receives a base fee equal to 2 percent of assets under management plus an incentive fee equal to 20 percent of all returns in excess of a specified IRR. This fee is commensurate and at market. Entity A also maintains a defined benefit pension plan (the “Plan”) for its employees. The Plan currently holds a 15 percent interest in the investment fund. The Plan maintains a diversified investment portfolio that includes a combination of investment funds that are managed by A and third parties. Further, the Plan's portfolio is adequately designed to meet the Plan's obligations. Entity A holds no other direct or indirect interests in the fund, and the fund is a VIE.

Although A, as the Plan's sponsor, has an obligation to fund the Plan to ensure that it can meet its obligations, given the Plan's design and the diversified nature of its portfolio, it does not appear that A is using the Plan to circumvent the provisions of the VIE model. Accordingly, in applyingASC 810-10-55-37, A excludes the holdings of the Plan and concludes that it is performing its services in a fiduciary capacity because (1) its fee is commensurate and at market and (2) it has no other interest in the investment fund.

However, if A were to conclude that it has a variable interest in the fund (e.g., because A's fee arrangement is not commensurate or at market), it would need to consider all of its interests, including its exposure through its employees (employee benefit plans) in determining whether it is the primary beneficiary of the fund.

4.4.2.3.6 Employer Financed Plans

A decision maker may provide nonrecourse financing (or guarantee third-party financing) to allow its employees to purchase interests in a legal entity that it manages. Even though the decision maker may have economic exposure to the potential VIE through its employees, it would exclude any exposure that it has through these arrangements when evaluating whether its fee arrangement represents a variable interest unless those interests are used in an effort to circumvent the provisions of the VIE model. For example, if the financing was provided to the employee as part of the design of a specific fund as a means to increase the decision maker's exposure to the fund, it is likely that the reporting entity would conclude that the purpose of providing the financing was to circumvent these provisions. Conversely, if the decision maker offers nonrecourse financing to its employees to invest in a fund that it manages as an employee benefit, it is unlikely that the reporting entity would conclude that the financing was used to circumvent this guidance.

However, if the decision maker determines that its fee arrangement is a variable interest, the decision maker would include its indirect exposure to the VIE through its employees in the primary-beneficiary evaluation. Finally, if the decision maker determines that it does not have a variable interest through its fee arrangement as a result of excluding its exposure through financing its employee's interests, the decision maker should consider whether it is required to disclose its indirect interests in the legal entity through its financing arrangement as part of its VIE disclosures.

4.4.2.3.7 Fee Arrangements Through a Related Party

In the determination of whether fees paid to decision makers or service providers represent variable interests, ASC 810-10-55-37(c) requires the decision maker to analyze whether it holds other interests, directly or indirectly through its related parties, that absorb more than an insignificant amount of the expected losses or the expected residual returns of the legal entity being analyzed. When evaluating whether a decision maker absorbs any economic exposure to a legal entity through its related parties, the decision maker would not include fee arrangements that it has with its related party in determining its indirect exposure to the legal entity being analyzed, unless the fee arrangement is a variable interest. That is, as long as the decision maker does not have any variable interests in the related party, the decision maker would not include any of its related party's interests in its evaluation.
However, if the decision maker holds a variable interest in its related party, it would include its indirect exposure through those interests in its related parties in its evaluation.

**Example 4-35**

The asset manager, as general partner, is responsible for all of the investment decisions of the master fund. The asset manager cannot be removed and, therefore, in accordance with ASC 810-10-15-14(b)(1)(ii), the master fund is considered a VIE. The asset manager, through a service arrangement, is also responsible for making all the investment decisions for the feeder fund.

In return for its services, the asset manager receives a base management fee and a performance fee from the feeder fund that are commensurate and at market. In addition, the asset manager has determined that the feeder fund is a voting interest entity. The remaining investors of the master fund are other feeder funds managed by the asset manager. The asset manager receives a similar fee arrangement from those feeder funds. Therefore, the asset manager does not receive an additional fee for its service to the master fund; however, the overall fee structure is considered commensurate and at market.

The asset manager is required to analyze whether its general partner interest in the master fund is a variable interest in accordance with ASC 810-10-55-37 (see Section 4.4.1.4). When performing this evaluation, the asset manager is required to consider both its direct and its indirect exposure to the master fund through its related party (feeder fund). In this case, although the fee received from the feeder fund represents a variable interest in the feeder fund (as a result of the other interests held by the asset manager), the asset manager would only be required to include its 25 percent interest in the feeder fund when evaluating its exposure on an indirect basis. That is, in this example, the asset manager would include its 7.5 percent indirect interest in the master fund (its share on a proportionate basis — 25 percent of 30 percent) through the feeder fund in both its evaluation of whether the fee represents a variable under ASC 810-10-55-37 and its economics-criterion evaluation under ASC 810-10 25-38A(b) (see Section 7.3). However, if the asset manager did not have a direct investment in the feeder fund, it would not include any of the feeder fund’s investment when evaluating its economic exposure to the master fund.

**4.4.3 Reassessment of Whether a Decision Maker’s or Service Provider’s Fee Is a Variable Interest**

ASC 810-10-55-37 provides three criteria that, if met, would result in the determination that a decision maker’s or service provider’s fee arrangement is not a variable interest and that therefore the decision maker or service provider is acting as a fiduciary of the legal entity’s variable interest holders. Changes in a legal entity’s facts and circumstances associated with these three criteria will need to be carefully evaluated in the assessment of whether a fee arrangement becomes (or is no longer) a variable interest.
4.4.3.1 Reassessment of Commensurate and At-Market Criteria

The decision maker or service provider is not required to reconsider its previous conclusions about whether a fee arrangement is commensurate and at market (see Section 4.4.1) unless (1) the fee arrangement itself was significantly modified or (2) the responsibility of the decision maker or service provider significantly changes (e.g., the legal entity undertakes additional activities or acquires additional assets that were not anticipated as of the date of the previous determination). That is, it would not be appropriate to reconsider the commensurate and at-market criteria if a reconsideration event unrelated to the fee arrangement occurs or the responsibility of the decision maker or service provider does not change.

Example 4-36

Entity A manages an investment fund in exchange for a fixed annual fee equal to 50 basis points of assets under management and a variable fee equal to 20 percent of all returns in excess of an 8 percent IRR. Entity A determined that the fees are commensurate and at market. Subsequently, A purchases 5 percent of the outstanding interests in the investment fund from an unrelated third party. At the time of the purchase, the fee arrangement is no longer commensurate because the market now offers only 10 percent of all returns in excess of an 8 percent IRR. It would be inappropriate to reconsider the commensurate and at-market criteria because the fee arrangement was not modified and the investment fund did not undertake additional activities or acquire additional assets. However, as discussed below, other interests must be reconsidered.

4.4.3.2 Reassessment of the Other-Interests Criterion

A reporting entity is required to reconsider whether a fee meets the criterion in ASC 810-10-55-37(c) regarding other interests when there has been (1) a change in the design of the legal entity, (2) an acquisition or disposal of other variable interests in the legal entity by the decision maker or service provider (including an interest held through a related party), (3) a change in a related-party relationship, or (4) a significant change in the economic performance of the legal entity and that change is expected to continue throughout the life of the legal entity.

The reconsideration events in ASC 810-10-35-4(a)-(d) (see Chapter 9) focus on changes in the legal entity’s design. Therefore, if one of those events occurs, a decision maker or service provider would need to reassess, concurrently with its reconsideration of the legal entity’s status as a VIE, and on the basis of facts and circumstances that exist as of the date of the reconsideration event, whether its fee meets the condition in ASC 810-10-55-37(c).

ASC 810-10-35-4 indicates that a “legal entity that previously was not subject to the Variable Interest Entities Subsections shall not become subject to them simply because of losses in excess of its expected losses that reduce the equity investment.” Therefore, a reporting entity would typically not be required to reassess whether its fee meets the other interests condition as a result of changes in general market conditions or changes in the economic performance of the legal entity. However, if a significant change occurs in the economic performance of the legal entity, and the change is expected to continue throughout the life of the legal entity, the decision maker or service provider may no longer be serving in a fiduciary capacity (or as a principal).
Example 4-37

An investment manager creates a CLO and retains a 12 percent residual interest in the entity. For its role as collateral manager, the investment manager receives remuneration that is customary and commensurate with services performed, including a senior management fee that is paid senior to the notes, a subordinate management fee that is paid senior to the CLO’s preferred shares, and an incentive fee.

The investment manager initially has the power to direct the activities that most significantly affect the CLO’s economic performance. In addition, the residual interest owned by the investment manager absorbs more than an insignificant amount of the CLO’s variability; therefore, the investment manager would consolidate the CLO. Subsequently, as a result of the economic performance of the underlying securities in the CLO, the residual interest holders will not receive any future cash flows from the legal entity. Accordingly, the investment manager would reassess whether its fee is a variable interest under ASC 810-10-55-37 and whether it continues to be the primary beneficiary.

Example 4-38

Company R establishes a real estate partnership (a VIE), provides 1 percent of the partnership’s capital investments, and manages its activities under a separate management contract. For its role as manager, R receives remuneration that is customary and commensurate with services performed. In addition, R separately has guaranteed the performance of the real estate properties for the first three years after the partnership’s formation and, as a result, will absorb more than an insignificant amount of the partnership’s expected losses.

During the three-year guarantee period, R has a variable interest in the partnership through its management fee and its performance guarantee. Company R has the power to direct the activities that most significantly affect the partnership’s economic performance. In addition, R’s guarantee absorbs more than an insignificant amount of the partnership’s variability; therefore, R would consolidate the partnership. After the three-year guarantee period, since there is no possible scenario in which R will have to perform under the guarantee in the future, R would reassess whether its fee is a variable interest under ASC 810-10-55-37 and whether it continues to be the primary beneficiary.
Chapter 5 — Determining Whether a Legal Entity Is a VIE

5.1 Introduction

**ASC 810-10**

25-37 The initial determination of whether a legal entity is a VIE shall be made on the date at which a reporting entity becomes involved with the legal entity. For purposes of the Variable Interest Entities Subsections, involvement with a legal entity refers to ownership, contractual, or other pecuniary interests that may be determined to be variable interests. 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.

To determine which consolidation model a reporting entity should apply to evaluate its variable interest in a legal entity, the reporting entity must determine whether the legal entity is a VIE. This determination must be made upon a reporting entity’s initial involvement with a legal entity and reassessed upon the occurrence of a reconsideration event (see Chapter 9 for a discussion of VIE reconsideration events). If the legal entity is a VIE, a reporting entity with a variable interest (see Chapter 4) in that legal entity applies the VIE provisions of ASC 810-10 to determine whether it must consolidate the legal entity. If a legal entity is not a VIE, it is considered a voting interest entity, and a reporting entity applies the voting interest entity model to determine whether it must consolidate the legal entity (see Appendix D for a discussion of the voting interest entity model).

The consolidation conclusions under the VIE model can be different from those under the voting interest entity model. Because the differences between a VIE and a voting interest entity can be subtle, a reporting entity must have a complete understanding of all contractual arrangements (explicit and implicit) as well as the design and purpose of the legal entity.
Legal entities can differ in structure as well as legal form (e.g., corporations compared with limited partnerships and similar entities), which affects the method used to understand their design and purpose. In simple terms, the distinction is based on the nature and amount of the equity investment and the rights and obligations of the equity investors. If a legal entity has sufficient equity investment at risk to finance its operations, and those equity investors, through their equity investment at risk, make decisions that direct the significant activities of the legal entity, consolidation based on majority voting interest is generally appropriate. However, if equity is not sufficient, or the equity investors do not control the legal entity through their equity investment, the VIE model is used to identify the appropriate party, if any, to consolidate.

To qualify as a VIE, a legal entity needs to satisfy only one of the following characteristics (which are discussed in detail in the sections below):

- The legal entity does not have sufficient equity investment at risk (Section 5.2).
- The equity investors at risk, as a group, lack the characteristics of a controlling financial interest (Section 5.3).
- The legal entity is structured with disproportionate voting rights, and substantially all of the activities are conducted on behalf of an investor with disproportionately few voting rights (Section 5.4).

### 5.1.1 Application of VIE Guidance to Multitiered Legal-Entity Structures

Section 3.2.2 describes the application of the VIE framework to multitiered legal-entity structures, noting that such an analysis begins at the bottom and proceeds to the top. Each entity within the structure should then be evaluated on a consolidated basis. The attributes and variable interests of the underlying consolidated entities generally should become those of the parent company upon consolidation. As a result of this framework, in certain structures, if a lower-tiered legal entity is a VIE and consolidated by another legal entity (its parent), the parent may as a result be determined to be a VIE. For example, if the lower-tiered legal entity is a VIE because of insufficiency of equity investment at risk, when those attributes become those of the parent, the parent may also be determined to be a VIE depending on the design of the legal entity and whether the parent has other substantive activities or consolidated subsidiaries (see Examples 3-4 and 3-5 in Section 3.2.2).

### 5.1.2 Anticipating Changes in the Design of a Legal Entity

In general, the assumptions a reporting entity uses to determine whether a legal entity is a VIE are limited by the legal entity’s design as of the assessment date. In its evaluation, the reporting entity should not consider contractual changes to the legal entity’s design that are anticipated but not required. The governing documents and contractual arrangements establish a legal entity’s design and usually give insight into why the legal entity was formed and the primary activities it is expected to perform.

However, it would be appropriate to consider activities (and the potential funding sources of those activities) that are expected to be undertaken by the legal entity in its ordinary course of business as a result of its design. While a reporting entity must use judgment in determining whether an assumption is within the scope of the legal entity’s design, it would be appropriate to assume that the legal entity will enter into sales and purchase contracts as part of its ordinary course of business because its ability to enter into such contracts affects the variability in the designed operations.
5.2 Sufficiency of Equity

A legal entity shall be subject to consolidation under the guidance in the Variable Interest Entities Subsections if, by design, any of the following conditions exist. (The phrase by design refers to legal entities that meet the conditions in this paragraph because of the way they are structured. For example, a legal entity under the control of its equity investors that originally was not a VIE does not become one because of operating losses. The design of the legal entity is important in the application of these provisions.)

a. The total equity investment (equity investments in a legal entity are interests that are required to be reported as equity in that entity’s financial statements) at risk is not sufficient to permit the legal entity to finance its activities without additional subordinated financial support provided by any parties, including equity holders. For this purpose, the total equity investment at risk has all of the following characteristics:

1. Includes only equity investments in the legal entity that participate significantly in profits and losses even if those investments do not carry voting rights
2. Does not include equity interests that the legal entity issued in exchange for subordinated interests in other VIEs
3. Does not include amounts provided to the equity investor directly or indirectly by the legal entity or by other parties involved with the legal 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
4. Does not include amounts financed for the equity investor (for example, by loans or guarantees of loans) directly by the legal entity or by other parties involved with the legal 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.

Paragraphs 810-10-25-45 through 25-47 discuss the amount of the total equity investment at risk that is necessary to permit a legal entity to finance its activities without additional subordinated financial support.

A legal entity is not a VIE under this criterion if its total equity investment at risk is sufficient to finance its activities without additional subordinated financial support. In establishing this guidance, the FASB reasoned that an equity investment that is not sufficient to permit a legal entity to finance its own activities without additional subordinated financial support indicates that an analysis of voting rights is not an effective way to determine whether a reporting entity has a controlling financial interest in the legal entity. Therefore, the owner of a majority residual interest in a legal entity with insufficient equity may not be the appropriate party to consolidate. Nevertheless, in many instances, an equity investor with a majority of the voting interests may still be deemed to hold a controlling financial interest and would therefore consolidate the VIE if it is the party that has the power to direct the most significant activities of the VIE.

To determine whether there is sufficient equity investment at risk to permit the legal entity to finance its activities without additional subordinated financial support, a reporting entity must perform the following steps:

- **Step 1** — Identify whether an interest in a legal entity is considered GAAP equity.
- **Step 2** — Determine whether the equity investment is “at risk” on the basis of the equity investment population.
- **Step 3** — Determine whether the identified equity investment at risk is sufficient to finance the legal entity’s operations without additional subordinated financial support.
5.2.1 Identifying Whether an Interest in a Legal Entity Is Considered GAAP Equity (Step 1)

A reporting entity's ultimate goal in performing the assessment in ASC 810-10-15-14(a) is to determine whether a legal entity is sufficiently capitalized with equity that has the characteristics typical of equity. Doing so requires identification of equity investment at risk, which first requires identification of whether an interest is considered GAAP equity. For more information, see Deloitte's *A Roadmap to Distinguishing Liabilities From Equity*.

While only an equity interest can be considered equity investment at risk, not all equity interests will be considered equity investment at risk. An interest classified outside the equity section (permanent or temporary, as described in Section 5.2.1.1) of a legal entity's balance sheet is not an equity investment. Accordingly, an equity investment might include the following types of interest:

- Common stock.
- Preferred stock.
- Ownership interests in partnerships and similar entities.
- Certain beneficial interests in trusts and securitizations in the infrequent circumstances in which they are considered legal-form equity and classified as GAAP equity.

The above list is not comprehensive and does not suggest that those interests are equity investments; rather, it illustrates only that the types of interests qualifying as equity may be diverse. However, the interests must be classified as GAAP equity for accounting purposes under U.S. GAAP. This distinction applies even when the interest does not convey the right to vote on decisions of the legal entity. By extension, the following types of interests can never be considered equity for this purpose:

- Debt.
- A legal-form equity interest, including common stock, preferred stock, or ownership interests in partnerships and similar legal entities, that is classified as a liability under ASC 480-10.
- Commitments to fund equity or to absorb losses.
- Personal guarantees by an equity holder.

Interests that are not classified at the time of evaluation as equity for accounting purposes cannot meet the definition of an equity investment at risk. This applies even if an interest classified outside of equity has characteristics that are very similar to equity (e.g., a shareholder loan recognized outside of equity).

5.2.1.1 Mezzanine or Temporary Equity

Instruments accounted for as mezzanine or temporary equity would qualify for inclusion in a legal entity's total equity investment at risk if those instruments meet the conditions in ASC 810-10-15-14(a). This guidance is consistent with ASC 815-10-15-76, which indicates that “[t]emporary equity is considered stockholders' equity for purposes of the scope exception in paragraph 815-10-15-74(a) even if it is required to be displayed outside of the permanent equity section.”

However, interests classified as temporary equity may not significantly participate in the profits and losses of the legal entity and thus fail to meet the requirement in ASC 810-10-15-14(a)(1) for inclusion in equity investment at risk (see Section 5.2.2).
5.2.1.2 Personal Guarantee or Commitment to Fund

If an amount has only been guaranteed or committed (and not funded) by the equity holder as of the date of the VIE analysis, neither the amount guaranteed nor the fair value of the guarantee is considered equity investment at risk.

5.2.1.3 Instruments With a Similar Risks-and-Rewards Profile of Equity

A legal entity may be capitalized with equity as well as with other instruments that cannot be reported as equity under U.S. GAAP in the legal entity’s financial statements (e.g., participating subordinated debt). Sometimes the risks-and-rewards profile of such an instrument is similar to that of an equity investment. Whether interests in a legal entity qualify as equity investment at risk depends, in part, on their form. Instruments that cannot be reported as equity in a legal entity’s financial statements cannot qualify as equity investment at risk.

ASC 810-10-25-47 describes the following situation in which subordinated debt does not qualify as equity investment at risk:

[i]f a legal entity has a very small equity investment relative to other entities with similar activities and has outstanding subordinated debt that obviously is effectively a replacement for an additional equity investment, the equity would not be expected to be sufficient.

5.2.1.4 Equity of a Foreign Entity

An interest that is classified as equity under foreign GAAP does not automatically result in a conclusion that it represents equity investment at risk under ASC 810.

Example 5-1

A reporting entity holds a variable interest in a foreign entity that prepares its financial statements in accordance with its home-country GAAP. The reporting entity has an investment in the foreign entity that is classified as equity under the investee’s foreign GAAP but that does not qualify as equity under U.S. GAAP. This interest is not an equity investment under the VIE model. Even though the foreign entity reports the instrument as equity under its home-country GAAP, the financial instrument in the foreign entity still must qualify for recognition as equity under U.S. GAAP.

5.2.2 Determining Whether the Equity Investment Is “At Risk” (Step 2)

An interest classified as equity may not have the substantive characteristics of equity. Since the VIE consolidation framework is intended to apply to entities whose equity voting interests may not be the most appropriate determining factor in the identification of which party should consolidate, the FASB reasoned that equity interests that are not “at risk” should not be included in the sufficiency-of-equity test. To be considered part of the equity investment at risk, equity interests must:

- Participate significantly in profits and losses.
- Not be issued in exchange for subordinated interests in other VIEs.
- Not be received from the legal entity or by parties involved with the legal entity unless that party is a parent, a subsidiary, or an affiliate of the investor that is required to be included in the same set of consolidated financial statements as the investor.
- Not be financed by the legal entity or other parties involved with the legal entity unless that party is a parent, a subsidiary, or an affiliate of the investor that is required to be included in the same set of consolidated financial statements as the investor.
5.2.2.1 Significant Participation in Profits and Losses

Equity investment at risk includes only equity investments in the legal entity that participate significantly in profits and losses even if those investments do not carry voting rights. This characteristic is based on the contractual rights of an equity investment, not an assessment of probability. The determination of whether a legal entity participates significantly in profits and losses should be based on the legal entity’s profits and losses under GAAP, not the legal entity’s variability in returns (i.e., expected losses and expected residual returns; see Section 2.3). An equity investment must participate significantly in both profits and losses. An interest that participates in one but not the other is not at risk.

A reporting entity must determine whether an equity instrument participates significantly in the profits and losses of the potential VIE as a whole on the basis of the design of the potential VIE as of the date of the evaluation under ASC 810-10-15-14(a). Generally, instruments that participate on a pro rata basis in the profits and losses, based on GAAP, of all the potential VIE’s assets and liabilities are considered to participate significantly in the profits and losses of the potential VIE as a whole. By contrast, instruments that participate in the profits and losses of specified assets may not be considered to participate significantly in the profits and losses of the potential VIE as a whole and therefore would not qualify as equity investment at risk.

Example 5-2

A limited partnership is formed in which the general partner holds a 2 percent interest and the limited partners hold the remaining equity interests. Profits and losses of all assets and liabilities of the partnership are distributed pro rata according to ownership interests. There are no other arrangements between the entity and the general and limited partners. In this scenario, even though the general partner only absorbs and receives 2 percent of the profits and losses of the limited partnership, its equity interest participates pro rata in the profits and losses of the limited partnership. Therefore, the general partner’s equity interest participates significantly in the profits and losses of the limited partnership.

Example 5-3

Two unrelated parties, Enterprise A and Enterprise B, each contribute $10 million for equity investments in a legal entity. The legal entity uses the proceeds from the equity issuance, along with another $80 million obtained from the issuance of debt, to invest in two buildings, each worth $50 million. The common stock is classified in equity. Enterprise A contractually absorbs only the profits and losses of Building 1, and B contractually absorbs only the profits and losses of Building 2. In this example, even though the common stock is classified in equity, neither the equity of A nor that of B qualifies as an equity investment at risk because neither significantly participates in the profits and losses of the entity as a whole. The parties should evaluate their interest under the “silo” provisions in ASC 810-10-25-57 to determine whether silos exist (see Chapter 6).

5.2.2.1.1 Fixed-Rate, Nonparticipating Preferred Stock

Fixed-rate, nonparticipating preferred-stock or other fixed-return instruments classified in equity typically would not participate in fluctuations in a legal entity’s profits and losses. Accordingly, such interests typically would not participate significantly in the legal entity’s profits and losses. A reporting entity may determine, upon evaluating all the facts and circumstances, that a fixed-rate instrument participates significantly in the profits and losses of the legal entity. For example, the legal entity may have very little expected variability in profits and losses (e.g., the legal entity holds fixed-rate assets that have little risk).
5.2.2.1.2 Contracts and Instruments That Protect an Equity Investor

Contracts and instruments that are separate from the equity interest and entered into with a party other than the investee generally do not cause the equity investment to fail to be at risk.

Whether an equity interest participates significantly in the profits and losses of a legal entity generally is only based on the terms of the contracts or instruments with the legal entity. Therefore, a contract or instrument entered into with a party other than the investee that is separate from the equity interest itself does not disqualify the equity investment from being at risk. Contracts and instruments may affect the holder's total return but do not directly affect returns from the legal entity on the equity investment. Therefore, the equity investment would be at risk as long as it meets the other conditions in ASC 810-10-15-14(a).

Put rights, total return swaps, guarantees, and similar arrangements with parties related to the legal entity may result in a conclusion that the equity interest is not at risk under ASC 810-10-15-14(a)(4) (see Section 5.2.2.4.1).

Note that if the direct holder of the equity interest is acting solely as an agent for the counterparty to the other instrument or contract, a reporting entity should attribute the direct holding to the counterparty in evaluating the accounting requirements under the VIE model.

5.2.2.2 Equity Investments Issued in Exchange for Subordinated Interests in Other VIEs

Equity investment at risk does not include equity interests that the legal entity issued in exchange for subordinated interests in other VIEs. An equity interest can be considered at risk for only one legal entity.

Example 5-4

Entity A (the reporting entity) contributes cash to Entity B (a legal entity that is a VIE) in exchange for common stock. Entity A contributes its investment in B to Entity C (a newly formed legal entity) in exchange for common stock. Each common stock investment is classified as equity in the balance sheet of the respective issuer. By using its investment in B to fund its investment in C, A has received an equity investment in exchange for a subordinated interest in another legal entity. Without this condition, the equity investment in both B and C, though funded with only one cash contribution, might be considered at risk. For this reason, the common stock in C is not considered to be at risk.

5.2.2.3 Equity Investments Provided to the Equity Investor by the Legal Entity or by Parties Involved With the Legal Entity

Equity investment at risk does not include amounts (e.g., fees, charitable contributions, or other payments) provided to the equity investor directly or indirectly by the legal entity or by other parties involved with the legal entity unless the provider is a parent, subsidiary, or affiliate of the investor that must be included in the same set of consolidated financial statements as the investor.

ASC 810-10-15-14(a) requires the reporting entity to identify whether equity investment is at risk (i.e., to determine whether the equity investor’s “skin in the game” is sufficient to warrant a consolidation analysis under the voting interest entity model). If an equity investment is accompanied by a contemporaneous return of investment — or a guaranteed return of investment — the substance of the investment is not at risk. That is, if the equity investor is assured a return of investment at the time of making its investment, the transaction contains a round-trip component. If the equity investment is removed immediately from the legal entity, or otherwise returned to the investor by a party involved with the legal entity, the risk of loss is removed.
Entities Z and X (both reporting entities) form Entity Y (a legal entity). Entities Z and X each contribute cash to Y in exchange for common stock in Y. Concurrently with this transaction, X agrees to pay Z an up-front fee equal in amount to Z’s cash investment in Y. In this circumstance, though Z has not withdrawn its cash investment in Y, because it has received a cash payment equal in amount to the cash investment, the equity investment contributed by Z is not considered to be at risk.

Considerable judgment is required in the assessment of an arrangement’s facts and circumstances to determine whether the arrangement represents a return of investment sufficient to disqualify an equity interest from treatment as equity investment at risk. Matters requiring assessment include the type, timing, source, and amount of a payment as well as whether the payment is contingent on any circumstances. For example, a fee arrangement after the formation of a venture, in which a venturer is paid an at-market fee for providing services to the venture, does not reduce the equity investment at risk. ASC 810-10-15-14(a) specifically excludes arrangements between a parent, a subsidiary, or an affiliate of the equity investor when that party is required to be included in the same consolidated financial statements as the investor. Such a circumstance does not involve a return of investment but instead merely reshuffles it through intercompany accounts without affecting the consolidated financial statements.

5.2.2.3.1 Equity Received for Promises to Perform Services (“Sweat Equity”) Equity investments acquired by an equity investor in exchange for promising to perform services, commonly referred to as “sweat equity,” cannot be included in equity investment at risk, because the equity is received in lieu of a fee for services performed. Similarly, equity investments acquired as a result of past services performed are not considered equity investment at risk.

Example 5-6 Three investors form Entity X to conduct research and development activities. Entity X issues equity with a par amount of $15 million ($5 million to each investor). Investor A contributes $5 million in cash. Investor B issues a guarantee that the fair value of the completion of the research and development activities will be at least $90 million. Investor C enters into an agreement with X to provide research scientists who will each work for 500 hours to complete the activities.

Only A's $5 million in equity is considered equity at risk because B and C received their equity as payment from X for the guarantee (promise to stand ready) and the performance of services, respectively.

5.2.2.3.2 Fees Received for Services Performed at Inception or in the Future Fees paid or the incurrence of an obligation to pay fees to the equity investor at the inception of the potential VIE (e.g., a developer or structuring fee) typically reduces the potential VIE’s equity investment at risk. The amount of the fee represents a return of the investor's equity at risk. Since the equity investment is returned (or will be returned over time in the form of a payable), the portion of the investor’s equity investment returned in fees is not at risk.

By contrast, if the fees expected to be paid to, or incurred by, the investor in the future are commensurate with the service to be provided (at market rates), the equity investment at risk should not be reduced for these future fees. If future fees are in excess of market rates, and the equity investor is unconditionally entitled to the fees, the present value of the excess should reduce the potential VIE's equity investment at risk because the above-market fees received are, in substance, a guaranteed return of equity.
5.2.2.4 Equity Financed for the Equity Investor by the Legal Entity or Other Parties Involved With the Legal Entity

Equity investment at risk does not include amounts financed for the equity investor (e.g., by loans or guarantees of loans) directly by the legal entity or by another party involved with the legal 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 does not mean that a reporting entity must use its own capital (i.e., not have borrowing relationships) to acquire an interest in a legal entity. Rather, the reporting entity should use judgment and analyze the individual facts and circumstances carefully. For example, a reporting entity may borrow cash from a third-party bank and use a portion of the proceeds on borrowing to fund an equity investment in a legal entity. This situation is clearly different from one in which, instead of a third-party bank, the reporting entity borrows directly from the legal entity.

Transactions and relationships existing “around the legal entity” (see Section 4.3.10.1) are relevant in this assessment. This concept was discussed at the 2004 AICPA Conference on Current SEC and PCAOB Developments by an SEC staff member, Associate Chief Accountant Jane Poulin, who stated, in part:

We have seen a number of questions about whether certain aspects of a relationship that a variable interest holder has with a variable interest entity (VIE) need to be considered when analyzing the application of FIN 46R. These aspects of a relationship are sometimes referred to as “activities around the entity.” It might be helpful to consider a simple example. Say a company (Investor A) made an equity investment in a potential VIE and Investor A separately made a loan with full recourse to another variable interest holder (Investor B). We have been asked whether the loan in this situation can be ignored when analyzing the application of FIN 46R. The short answer is no. First, FIN 46R specifically requires you to consider loans between investors as well as those between the entity and the enterprise in determining whether equity investments are at risk, and whether the at risk holders possess the characteristics of a controlling financial interest as defined in paragraph 5(b) of FIN 46R [ASC 810-10-15-14(b)]. It is often difficult to determine the substance of a lending relationship and its impact on a VIE analysis on its face. You need to evaluate the substance of the facts and circumstances. The presence of a loan between investors will bring into question, in this example, whether Investor B’s investment is at risk and depending on B’s ownership percentage and voting rights, will influence whether the at risk equity holders possess the characteristics of a controlling financial interest.

Other “activities around the entity” that should be considered when applying FIN 46R include equity investments between investors, puts and calls between the enterprise and other investors and non-investors, service arrangements with investors and non-investors, and derivatives such as total return swaps. There may be other activities around the entity that need to be considered which I have not specifically mentioned. These activities can impact the entire analysis under FIN 46R including the assessment of whether an entity is a VIE as well as who is the primary beneficiary. [Footnotes omitted]

If financing of the equity investment is provided to the equity investor by an unrelated third party that is not involved with either the legal entity or other parties involved with the legal entity, the investment can be treated as equity investment at risk as long as the other criteria in ASC 810-10-15-14(a) are also met. Conversely, if one equity investor provides financing to another equity investor, the investment made by the equity investor who received the financing generally would be excluded from equity investment at risk.

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1 This relationship may be an indicator of a de facto agency relationship under ASC 810-10-25-43(b). See Section 8.2.3.2.
In unusual circumstances, the equity investment may be at risk when (1) one equity investor provides financing to another equity investor and (2) the borrowing equity investor is acting solely in the capacity of agent for the other equity investor (see Example 5-9 below).

**Example 5-7**

Enterprises A, B, and C each contribute $100 to form Entity D. Enterprise A’s $100 contribution was funded by a loan from Bank Z (an unrelated enterprise). Therefore, A’s equity does not fail to meet the criterion in ASC 810-10-15-14(a)(4) because its loan was from an unrelated party that is not involved with either the legal entity or other parties involved with the legal entity.

**Example 5-8**

Enterprises A, B, and C each contribute $100 to form Entity D. Enterprise A’s $100 contribution was funded by a loan from Enterprise B (a bank), another party involved with D. Assume that A is not acting as an agent for B. In addition, B does not have to be included in A’s consolidated financial statements.

Enterprise A has financed its equity investment by obtaining a loan directly from another party that is involved with D. Subsequently, A’s equity fails to meet the criterion in ASC 810-10-15-14(a)(4) because its loan was from another party involved with D that does not need to be included in A’s consolidated financial statements. Therefore, A’s $100 contribution would not qualify as equity investment at risk.

**Example 5-9**

Enterprises B and C each contribute $50 to form a legal entity. Enterprise B funds its equity investment by obtaining a $50 loan from C. Under a separate agreement, B is required to vote its interest in the legal entity (in all matters) in accordance with C’s instructions; therefore, a principal-agent relationship exists. Assume that B and C are not included in the same set of consolidated financial statements.

In this example, all of B’s equity is considered equity investment at risk. Even though B obtained its equity through a loan from C (a party involved with the entity), B’s equity is still considered equity investment at risk because B is merely acting as C’s agent.

### 5.2.2.4.1 Put Options, Call Options, and Total Return Swaps

An equity interest subject to a put option, call option, or total return swap in which the counterparty is a party unrelated to the legal entity would not disqualify the equity investment from being at risk. Depending on the terms, a purchased put, a written call, or a total return swap entered into by an equity investor with the potential VIE or a party involved with the potential VIE may result in the disqualification of the investor’s equity from being considered equity investment at risk under ASC 810-10-15-14(a)(1) or ASC 810-10-15-14(a)(4).
The following table provides an analysis of whether an equity interest subject to a purchased put, a written call, or a total return swap qualifies as equity investment at risk under ASC 810-10-15-14(a)(1) or ASC 810-10-15-14(a)(4), respectively:

<table>
<thead>
<tr>
<th>Original Reporting Entity Holds Equity in a Potential VIE and:</th>
<th>Counterparty Is:</th>
<th>Participates Significantly in Profits and Losses (Compliant With ASC 810-10-15-14(a)(1)?)</th>
<th>Not Financed by the Legal Entity or Certain Other Parties (Compliant With ASC 810-10-15-14(a)(4)?)</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Purchases a physically settled, fixed-price put on its equity investment.</strong></td>
<td>Unrelated to the potential VIE.</td>
<td>Yes. Although the original reporting entity is protected from losses via its fixed-price put option, the equity interest itself will remain outstanding even if the put is exercised; thus, the equity interest participates in both the profits and losses of the potential VIE.</td>
<td>Yes. The counterparty is not the potential VIE or another party involved with the potential VIE.</td>
</tr>
<tr>
<td><strong>Writes a physically settled, fixed-price call on its equity investment.</strong></td>
<td>Unrelated to the potential VIE.</td>
<td>Yes. Although the counterparty can obtain some of the original reporting entity's upside, the equity interest itself will remain outstanding even if the counterparty exercises its call; thus, the equity interest participates in both the profits and losses of the potential VIE.</td>
<td>Yes. The counterparty is not the potential VIE or another party involved with the potential VIE.</td>
</tr>
<tr>
<td><strong>Enters into a net-cash-settled total return swap indexed to the all-in return on its equity investment.</strong></td>
<td>Unrelated to the potential VIE.</td>
<td>Yes. The equity interest itself participates in both the profits and losses of the potential VIE.</td>
<td>Yes. The counterparty is not the potential VIE or another party involved with the potential VIE.</td>
</tr>
<tr>
<td><strong>Purchases a physically settled, fixed-price put on its equity investment.</strong></td>
<td>The potential VIE.</td>
<td>No. The fixed-price put option purchased from the potential VIE allows the original reporting entity to simply put its equity instrument to the potential VIE to protect it from incurring losses. Thus, the equity interest does not participate significantly in the potential VIE's losses.</td>
<td>No. The fixed-price put option purchased from the potential VIE is economically equivalent to the original reporting entity's receiving a loan guarantee from the potential VIE pertaining to the original reporting entity's investment in the potential VIE.***</td>
</tr>
<tr>
<td><strong>Writes a physically settled, fixed-price call on its equity investment.</strong></td>
<td>The potential VIE.</td>
<td>No. The fixed-price call option written to the potential VIE results in the significant participation of the original reporting entity only in the potential VIE's losses but not its profits (provided that the potential VIE acts rationally by exercising the call option when the fair value of the original reporting entity's equity interest exceeds the fixed strike price).</td>
<td>Yes. The equity interest was not &quot;financed&quot; by the potential VIE.</td>
</tr>
</tbody>
</table>
Table 5-1 — Analysis of Equity Interests

<table>
<thead>
<tr>
<th>Original Reporting Entity Holds Equity in a Potential VIE and:</th>
<th>Counterparty Is:</th>
<th>Participates Significantly in Profits and Losses (Compliant With ASC 810-10-15-14(a)(1)?)</th>
<th>Not Financed by the Legal Entity or Certain Other Parties (Compliant With ASC 810-10-15-14(a)(4)?)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Purchases a physically settled, fixed-price put on its equity investment.</td>
<td>A party related to the potential VIE.</td>
<td>Yes. Although the original reporting entity is protected from losses via its fixed-price put option, the equity interest itself will remain outstanding even if the put is exercised; thus, the equity interest participates in both the profits and losses of the potential VIE.</td>
<td>No. The fixed-price put option purchased from the party related to the potential VIE is economically equivalent to the original reporting entity's receiving a loan guarantee from the counterparty pertaining to the original reporting entity's investment in the potential VIE.** ***</td>
</tr>
<tr>
<td>Writes a physically settled, fixed-price call on its equity investment.</td>
<td>A party related to the potential VIE.</td>
<td>Yes. Although the counterparty can obtain some of the original reporting entity's upside, the equity interest itself will remain outstanding even if the counterparty exercises its call; thus, the equity interest participates in both the profits and losses of the potential VIE.</td>
<td>Yes. The equity interest was not &quot;financed&quot; by the party related to the potential VIE, except for deep in-the-money call options.</td>
</tr>
<tr>
<td>Enters into a net-cash-settled total return swap indexed to the all-in return on its equity investment.*</td>
<td>A party related to the potential VIE.</td>
<td>Yes. The equity interest itself participates in both the profits and losses of the potential VIE.</td>
<td>Generally, no. The total return swap entered into with a party related to the potential VIE is economically equivalent to the original reporting entity's receiving a loan from the counterparty to finance the original reporting entity's investment in the potential VIE. However, the equity investment may be at risk if the original reporting entity that holds the equity is acting solely as an agent for the other party related to the potential VIE. For guidance on determining whether the arrangement between the two equity investors is essentially a principal-agent relationship, see Section 5.2.2.4.**</td>
</tr>
</tbody>
</table>

* A total return swap on the equity interest is an arrangement in which (1) the original reporting entity will receive a fixed return (or variable interest rate return) and an amount equal to the decline in value of the equity interest and (2) the counterparty will receive all of the cash returns on the equity interest and the appreciation in value of the equity interest. In effect, a total return swap transfers substantially all of the risk and return related to the equity interest in the potential VIE without necessarily transferring the equity interest. See Section 4.3.7 for considerations related to whether a counterparty to a total return swap has a variable interest in the potential VIE.

** It is assumed in this example that the related party counterparty is not the reporting entity's parent, subsidiary, or affiliate that is required to be included in the same set of consolidated financial statements as the entity.
We have historically viewed fixed-price put options to be the economic equivalent of a loan. That view was premised on the fact that a nonrecourse loan and a purchased put option give an investor similar down-side protections. While we appreciate that some may continue to hold that view, our perspective on the issue has evolved. Although purchased put options and nonrecourse loans provide similar down-side protections, substantive differences between them exist related to form and substance. Notably, a loan provides capital to the investor to make an investment, whereas the purchased put option does not provide any capital to the option's holder up front. That is, a lender provides capital to the borrower when the lender extends a loan; an option's writer does not extend financing to the buyer of the put option up front. On the basis of that distinction, we have updated our interpretation related to this matter and believe that a purchased put option should be considered analogous to a loan guarantee. The down-side protection provided by the put option is economically equivalent to a guarantee of the financing deployed to invest in the entity. We do not believe that it matters whether the put option guarantees a lender's capital or that of the investor — we consider the two scenarios to be economically equivalent.

We understand that some may believe that as a result of such provisions, the put option's holder does not participate significantly in profits and losses because the investor with the put option is protected from the potential VIE's losses. In reaching this conclusion, some look to the remarks by SEC Associate Chief Accountant Jane Poulin at the 2004 AICPA Conference on Current SEC and PCAOB Developments (see Section 5.2.2.4).

5.2.3 Determining Whether the Identified Equity Investment at Risk Is Sufficient to Finance the Legal Entity's Operations Without Additional Subordinated Financial Support (Step 3)

Once the amount of equity investment at risk is quantified in step 1 (see Section 5.2.1) and step 2 (see Section 5.2.2), a reporting entity must determine whether the equity investment at risk is sufficient to finance the legal entity's operations without additional subordinated financial support. If not, the legal entity is a VIE. The purpose of this assessment is to identify whether a legal entity is sufficiently capitalized. Merely having at-risk equity is not enough; the legal entity must be able to finance its operations with that equity investment at risk. The reporting entity must use judgment to determine sufficiency since the various risk tolerances, investment objectives, and liquidity requirements of investing can influence the level of capital in a legal entity. The FASB's guidance below is intended to help the reporting entity determine whether equity investment at risk is sufficient.

**ASC 810-10**

25-45 An equity investment at risk of less than 10 percent of the legal entity's total assets shall not be considered sufficient to permit the legal 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. Qualitative assessments, including, but not limited to, the qualitative assessments described in (a) and (b), will in some cases be conclusive in determining that the legal entity's equity at risk is sufficient. If, after diligent effort, a reasonable conclusion about the sufficiency of the legal entity's equity at risk cannot be reached solely on qualitative considerations, the quantitative analyses implied by (c) shall 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 legal entity has demonstrated that it can finance its activities without additional subordinated financial support.

b. The legal 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 legal entity exceeds the estimate of the legal entity's expected losses based on reasonable quantitative evidence.
Some legal entities may require an equity investment at risk greater than 10 percent of their assets to finance their activities, especially if they engage in high-risk activities, hold high-risk assets, or have exposure to risks that are not reflected in the reported amounts of the legal entities’ assets or liabilities. The presumption in the preceding paragraph does not relieve a reporting entity of its responsibility to determine whether a particular legal entity with which the reporting entity is involved needs an equity investment at risk greater than 10 percent of its assets in order to finance its activities without subordinated financial support in addition to the equity investment.

The design of the legal entity (for example, its capital structure) and the apparent intentions of the parties that created the legal entity are important qualitative considerations, as are ratings of its outstanding debt (if any), the interest rates, and other terms of its financing arrangements. Often, no single factor will be conclusive and the determination will be based on the preponderance of evidence. For example, if a legal entity does not have a limited life and tightly constrained activities, if there are no unusual arrangements that appear designed to provide subordinated financial support, if its equity interests do not appear designed to require other subordinated financial support, and if the entity has been able to obtain commercial financing arrangements on customary terms, the equity would be expected to be sufficient. In contrast, if a legal entity has a very small equity investment relative to other entities with similar activities and has outstanding subordinated debt that obviously is effectively a replacement for an additional equity investment, the equity would not be expected to be sufficient.

Sufficiency of equity can be demonstrated by qualitative analysis, quantitative analysis, or a combination of both. However, the FASB clearly emphasized that a diligent qualitative assessment should be performed first, including whether (1) the legal entity has demonstrated that it can finance its activities without additional subordinated financial support and (2) the legal 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. If the qualitative analysis is not conclusive, the reporting entity can perform a quantitative analysis of whether the legal entity's equity investment at risk exceeds the legal entity's expected losses (see Appendix C for details on calculating expected losses). Conversely, if a qualitative assessment is conclusive, a quantitative approach is unnecessary.

The qualitative analysis requires, in part, a consideration of quantitative measures (e.g., percentage of equity investment at risk compared to total assets). To perform the assessment correctly, the reporting entity must first determine the appropriate ratio of equity investment at risk to total assets by comparing, on a fair value basis as of the assessment date, the equity investment at risk to total assets.

Under U.S. GAAP, a reporting entity must sometimes use carryover historical cost to record initial equity contributions made in the form of nonmonetary assets (e.g., formation of a joint venture or a contribution of nonmonetary assets pursuant to SAB Topic 5.G). Nonetheless, a reporting entity should use the fair value of the asset (e.g., fixed asset, intellectual property) as of the contribution date, not the carrying value of the asset in the contributor's books before the transfer, as the amount of the equity investment at risk.

When performing the quantitative assessment, the reporting entity should not include amounts reported as components of other comprehensive income or loss in the equity investment at risk. Because the assessment is performed on a fair value basis, such amounts are already reflected in the fair value of the equity investment at risk and therefore should not be double-counted.

ASC 810-10 provides a rebuttable presumption that a ratio of under 10 percent of equity investment at risk to total assets is not sufficient. This test is often misconstrued to mean that an equity investment in excess of 10 percent is sufficient. However, it should not be interpreted that way because the test is one directional and nondeterminative. The 10 percent presumption is intended to supersede guidance that
existed before the effective date of FIN 46(R), as explained in paragraph E23 in the Basis for Conclusions of FIN 46(R):

Because precisely estimating expected losses may be difficult and an entity may need an equity investment greater than its expected losses, the Board established a presumption that an equity investment is insufficient to allow an entity to finance its activities unless the investment is equal to at least 10 percent of the entity's total assets. Another reason for that presumption is to emphasize that the requirement for 3 percent equity referred to in EITF Issue No. 90-15, “Impact of Nonsubstantive Lessors, Residual Value Guarantees, and Other Provisions in Leasing Transactions,” is superseded and that an equity investment as small as 3 percent is insufficient for many variable interest entities. The Board intends that presumption to apply in one direction only. That is, an equity investment of less than 10 percent is presumed to be insufficient, but an equity investment of 10 percent is not presumed to be sufficient.

If the proportion of equity investment at risk to total assets (again, both on a fair value basis) is under 10 percent, additional facts and circumstances would be considered, and the hurdle for concluding that equity investment at risk is sufficient would be raised significantly.

There are two qualitative approaches to assessing the sufficiency of the legal entity's equity investment at risk. The first is to evaluate whether the legal entity has demonstrated that it can finance its activities without additional subordinated financial support. Such an evaluation will require consideration of facts and circumstances, and it may be difficult for the legal entity to demonstrate that it can finance its activities without such additional support when the legal entity is capitalized with a variety of forms of equity investment. Certain factors, such as the following, may indicate that a legal entity does not have sufficient equity investment at risk to finance its operations:

- The existence of non-investment-grade debt may indicate that a lender does not view the legal entity as having sufficient capitalization.
- A venture that has external borrowings that require a parental guarantee may likewise indicate that a lender does not view the legal entity as sufficiently capitalized. However, this could be overcome if the guarantees are normal for similar legal entities or if investment-grade debt could have been obtained in the absence of the guarantee (or both).

Other factors, such as the following, may indicate the opposite (i.e., that a legal entity does have sufficient equity investment at risk to finance its operations):

- The existence of investment-grade debt may indicate that third parties deem the legal entity to be sufficiently capitalized.
- The absence of subordinated financial support within the legal entity's capital structure may, depending on how long the legal entity has operated, indicate that the legal entity has the wherewithal to finance its own operations on the strength of its equity investment at risk alone.

The negative factors above may prove difficult to overcome. However, neither group of indicators is determinative nor should it be considered in isolation (i.e., without an assessment of the associated facts and circumstances). Reporting entities will need to exercise considerable judgment in qualitatively assessing sufficiency.
The second approach to assessing the sufficiency of the legal entity’s equity investment at risk is to evaluate evidence provided by other entities that have demonstrated their ability to finance operations without additional subordinated financial support. The comparable entities, however, must be extremely similar to the legal entity being analyzed. The following is a nonexhaustive list of the factors that should be considered in the assessment of similarity:

- The location of the entities, both physically and in terms of where the entities do business.
- The industry sector in which the entities operate.
- The size of the entities’ assets, liabilities, equity, results of operations, and cash flows.
- The risks to which the entities are exposed, both internally and externally.
- The regulatory environment in which the entities operate.

If, after using these approaches, the results are still inconclusive, a reporting entity would perform a quantitative analysis. In doing so, the reporting entity would determine whether the legal entity’s expected losses can be absorbed in total by the equity investment at risk or whether other instruments absorb expected losses (see Appendix C for guidance on calculating expected losses). In its simplest form, the quantitative analysis can be characterized as follows:

\[
\text{Equity investment at risk} > \text{Expected losses} = \text{Sufficient equity investment at risk}
\]

However, in a manner similar to the qualitative assessment described above, reporting entities must use judgment when performing the quantitative assessment.

**Example 5-10**

A legal entity is formed with (1) a $50 million equity investment that meets the conditions in ASC 810-10-15-14(a) for being “at risk” and (2) $950 million in high-credit-quality senior debt (e.g., AAA-rated). The high credit rating of the debt suggests the independent rating agencies believe that variable interests other than the debt holders will absorb the legal entity’s expected losses. If the only variable interest besides the debt is the equity, the equity is considered to be sufficient to finance the legal entity’s activities without additional subordinated financial support.

Although the reporting entity has reached a conclusion about the sufficiency of the legal entity’s equity at risk, the reporting entity must still analyze the legal entity to determine whether it fails to meet any of the characteristics in ASC 810-10-15-14(b) and (c) before concluding that the legal entity is not a VIE. See Sections 5.3 and 5.4, respectively.

**Example 5-11**

A legal entity is formed with (1) a 1 percent equity investment that meets the conditions in ASC 810-10-15-14(a) for being “at risk” and (2) 99 percent debt, which contractually receives a high rate of return in relation to the interest rate of an investment-grade instrument with similar terms. Since the legal entity only has 1 percent equity and has issued subordinated debt in exchange for agreeing to pay a high rate of return, a qualitative analysis would demonstrate that the legal entity is a VIE because the equity investment at risk is not sufficient.

Regardless of whether a reporting entity is analyzing a potential VIE qualitatively or quantitatively, any future financings that are required by the governing or contractual arrangements that exist as of the evaluation date (or that are contemplated by the involved parties in a manner consistent with the design of the potential VIE) should be included in the determination of the sufficiency of equity investment at risk. The reporting entity may only consider financings and activities associated with the current design of the potential VIE. Commitments to fund equity or to absorb losses are not considered GAAP equity (see Section 5.1.2).
The existence of a requirement to provide future financings does not automatically indicate that there is insufficient equity investment at risk to finance a legal entity's operations without additional subordinated financial support. A reporting entity should consider whether the legal entity can finance its current operations and activities with equity that exists as of the evaluation date and without additional subordinated financial support. The fact that equity commitments are outstanding does not necessarily mean that there is insufficient equity. For example:

- A commitment to fund future acquisitions or expansion activity would not necessarily indicate that a legal entity is insufficiently capitalized currently. The reporting entity should consider whether the acquisitions are currently necessary to operate the business.
- A legal entity may choose to fund a substantial amount of its capital with equity despite its ability to obtain investment-grade debt. Such a scenario is not an indicator that the legal entity's equity commitments outstanding are insufficient equity investment at risk if the legal entity has (1) received sufficient equity (i.e., without considering future equity to be received from equity commitments outstanding) to finance its operations without additional financial support and (2) elected to finance the remaining capital with additional equity.

Reporting entities should carefully consider all the facts and circumstances associated with future financing arrangements.

**Example 5-11A**

Investors A and B each contributed $20 million in return for an equity investment in Entity C, a legal entity that used the proceeds from the equity issuance to purchase a warehouse. Entity C plans to convert the warehouse into a condominium building, which it intends to sell upon completion of the conversion. In addition, A and B have each agreed to provide an additional $80 million of financing for the conversion on an as-needed basis. Because C was designed to purchase and convert the warehouse, the commitments made by A and B would lead to the conclusion that C is insufficiently capitalized and is therefore a VIE.

Note that C’s status as a VIE would need to be reconsidered upon each additional equity funding in accordance with the guidance in ASC 810-10-35-4(d). See Section 9.1.4 for additional information.

**Example 5-11B**

Company A forms Entity C to acquire and operate Company X. Company A contributes $100 million in return for an equity investment in C. In addition, Investor B, an unrelated third party, contributes $100 million in return for an equity investment in C. Company A and Investor B have each agreed to provide additional financing for any future acquisitions that C may make. Although A and B have agreed to fund C’s future acquisitions, this agreement alone would not lead to a conclusion that C is insufficiently capitalized. Because C was designed to purchase and operate X, the assessment of whether C is insufficiently capitalized should only include C’s current activities (i.e., acquiring and operating X).
5.2.3.1 Whether a Quantitative Analysis Overrides a Qualitative Analysis

A quantitative analysis will not override a conclusive qualitative analysis. In the VIE assessment, a qualitative assessment may be preferable to an expected loss calculation for the following reasons:

- The qualitative approach may help a reporting entity avoid the detailed estimates and computations of the quantitative approach (which could require significant effort and costs).
- While a quantitative approach may appear more precise and less subjective, the reporting entity may lack objective evidence on which to base the estimates and assumptions used to make the computation, resulting in imprecision and subjectivity.

Reasoned professional judgment that takes into account all facts and circumstances (including qualitative and quantitative considerations) is often as good as, or even better than, mathematical computations based on estimates and assumptions.

Example 5-12

Enterprise A contributes $1,000 in return for an equity investment in Entity B, a legal entity, which represents equity investment at risk. Enterprise A must assess whether B's equity at risk is sufficient to finance its activities without additional subordinated financial support. Enterprise A initially determines that the available qualitative evidence regarding the sufficiency of B's equity at risk is not conclusive. Therefore, A performs an expected loss calculation and determines that B's expected losses are $995.

Although B's $1,000 equity at risk exceeds the calculated expected losses of $995, the relatively insignificant difference between the two amounts provides little assurance that the quantitative approach alone is adequate in the assessment of the sufficiency of the equity at risk. In this case, A must consider this quantitative analysis as well as the qualitative evidence to determine whether B's equity at risk is sufficient.

5.2.3.2 Existence of Subordinated Debt

In a qualitative assessment of the sufficiency of equity investment at risk, the existence of subordinated debt is a factor indicating that a legal entity's total equity investment at risk may not be sufficient to absorb expected losses. That is, by virtue of its subordination, subordinated debt is expected to absorb expected losses beyond a legal entity's equity investment at risk. However, the existence of subordinated debt should not be considered determinative in itself; an evaluation of the sufficiency of equity at risk should be based on all facts and circumstances.

Example 5-13

Entity D is formed with $50 of equity investment at risk and $50 of long-term debt. The long-term debt consists of two issuances: Debt A, $45, and Debt B, $5. Debt B is subordinate to Debt A. Because D was recently formed, it could not obtain senior debt (Debt A) in an investment-grade form.

In a qualitative assessment, the existence of subordinated debt is a factor indicating that D does not have sufficient equity at risk. That factor should be considered along with all other facts and circumstances (e.g., a 50 percent ratio of equity at risk frequently exceeds expected losses). If the qualitative assessment is inconclusive, a quantitative analysis (i.e., calculation of expected losses/residual returns) should be performed to determine whether D is a VIE.
Example 5-14

Assume that in Example 5-13 it was determined that D was a VIE. Two years later, D engages in additional business activities beyond those that were considered at formation and is an established, profitable business. Given its desire to further expand its business, D issues a new tranche of debt (Debt C) whose rank is identical in seniority (e.g., priority in liquidation) to that of Debt B. Because of its stable financial condition, the tranche of debt is rated investment-grade. Given the identical priority in liquidation of Debt B and Debt C, one can infer that Debt A (which is senior to Debt B) and Debt B would be rated investment-grade as well. No other debt securities are outstanding, and no other evidence of subordinated financial support (e.g., guarantees) is noted. Assume that a reconsideration event under ASC 810-10-35-4(c) has occurred because the additional business activities increase D’s expected losses (see Chapter 9). Therefore, the variable interest holders must determine whether D is still a VIE.

In a qualitative assessment, D’s ability to issue investment-grade debt that has the same priority in liquidation as Debt B is one factor indicating that D, as of the reconsideration date, has sufficient equity at risk. In other words, in the absence of other forms of subordinated financial support, D would not have been able to obtain an investment-grade rating on the new debt if its existing equity at risk was not sufficient. However, all other facts and circumstances existing as of the reconsideration date should be considered. If the qualitative assessment is not conclusive, a quantitative analysis should be performed to determine whether D is a VIE as of the reconsideration date.

Example 5-15

Entity M is formed with equity and three issuances of debt. One of the debt instruments is investment-grade, while the other two are unrated debt. At formation, a qualitative assessment provides conclusive evidence that M has sufficient equity at risk. There are no other factors that would cause M to be a VIE.

Five years later, M has incurred losses in several periods and disposes of two significant lines of business. Entity M also obtains additional financing in the form of subordinated debt that is rated as below investment-grade. Entity M continues to maintain an investment-grade rating on its other tranches of debt. Assume that a reconsideration event under ASC 810-10-35-4(d) has occurred because M has curtailed its activities in a way that decreases its expected losses (see Chapter 9). Therefore, the variable interest holders must determine whether M is a VIE as of the reconsideration date.

While M continues to have investment-grade debt outstanding, the subsequent issuance of subordinated debt is, in a qualitative assessment, one factor indicating that M does not have sufficient equity at risk (in other words, if M had sufficient equity at risk to finance its activities, the issuance of subordinated debt that is below investment-grade would be unnecessary). However, all other facts and circumstances existing as of the reconsideration date should be considered. If the qualitative assessment is inconclusive, a quantitative analysis should be performed to determine whether M is a VIE as of the reconsideration date.

5.2.3.3 Determining Whether a Variable Interest Is Subordinated Financial Support

Not all variable interests should be considered subordinated financial support. Interests in a legal entity that are considered variable interests because they absorb expected losses of the legal entity are not necessarily subordinated financial support. Variable interests, as defined in ASC 810-10-20, are “contractual, ownership, or other pecuniary interests in a VIE that change with changes in the fair value of the VIE’s net assets exclusive of variable interests.” ASC 810-10-55-19 further indicates that variable interests absorb or receive the expected variability created by assets, liabilities, or contracts of a VIE that are not, themselves, variable interests.

The determination of whether a variable interest is subordinated financial support will be based on how that interest absorbs expected losses compared with other variable interests in the legal entity. The determination will be based on all facts and circumstances. If the terms of the arrangement cause the variable interest to absorb expected losses before or at the same level as the most subordinated
interests (e.g., equity, subordinated debt), or the most subordinated interests are not large enough to absorb the legal entity's expected losses, the variable interest would generally be considered subordinated financial support. For example, investment-grade debt is a variable interest that would generally not be considered subordinated financial support. See Section 4.2.1.2.3 for additional discussion.

**Example 5-16**

An investor holds a common-stock investment of $50 and a debt instrument of $60 in a legal entity. The only other variable interest is $40 of preferred stock held by an unrelated third party. The common and preferred stock are considered equity at risk in accordance with ASC 810-10-15-14(a), and the expected losses of the entity are $40. The entity is designed so that common and preferred stock absorb expected losses before the debt.

In this example, the common stock, preferred stock, and debt are all considered variable interests because they are expected to absorb some of the potential VIE's variability. However, because the common and preferred stock ($90) are expected to absorb 100 percent of the expected losses ($40), the debt is not considered subordinated financial support.

**5.2.3.4 Interaction Between Minimum Regulatory Capital and the Sufficiency of Equity Investment at Risk**

Certain entities operate in regulatory environments in which an external party — sometimes a governmental agency — establishes requirements for the minimum level of capital a reporting entity must maintain. For example, the levels of capitalization that reporting entities in the banking industry are required to maintain may be influenced by their exposure (i.e., financial positions taken, including derivative exposure). The minimum level of capital required by regulation may be less than the 10 percent rebuttable presumption discussed in Section 5.2.3. Although meeting the minimum level of regulatory capital is not enough evidence alone to support a conclusion that equity investment at risk is sufficient, the consideration of regulatory capital requirements (and compliance with those requirements) may be appropriate in the assessment of whether a legal entity has sufficient capital to finance its operations.

**5.2.4 Development-Stage Entities**

Before the adoption of ASU 2014-10, certain entities could qualify for specialized accounting under ASC 915 as development-stage entities. Such entities were, by definition, in a stage of development as opposed to conducting operations in accordance with their principal plan. Accordingly, those qualifying entities differed in nature from other entities, often being capitalized only to the extent required to perform a specific task related to development.

Although ASU 2014-10 removed the concept of a development-stage entity, we believe that it is still necessary to consider the design of a legal entity in the determination of whether its equity investment at risk is sufficient. That is, considering only the legal entity's current stage of development may be appropriate in the assessment of sufficiency of equity. Specifically, if a legal entity is in the development stage and there is substantial uncertainty about whether the legal entity will proceed to the next stage, it may be appropriate to consider only the current stage in the sufficiency assessment. This approach is consistent with the assessment of power of a multiple-stage entity. For additional discussion of whether

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2 ASU 2014-10 eliminated the specialized approach for considering sufficiency of equity investment at risk for development-stage entities. That guidance became effective for public business entities for annual periods beginning after December 15, 2015, and interim periods therein. For entities other than public business entities, the guidance became effective for annual periods beginning after December 15, 2016, and for interim periods beginning after December 15, 2017. As a result of these effective dates and early adoption, nearly all entities have adopted the ASU. Reporting entities that have historically applied this exception should consider the impact of ASU 2014-10 on their historical conclusions.
a substantive contingency exists regarding proceeding to the next stage of development, see Section 7.2.9.2.

A reporting entity should initially assess whether a development-stage entity is a VIE on the date on which it first becomes involved with the legal entity. This assessment must be reconsidered upon the occurrence of any of the events in ASC 810-10-35-4. For a development-stage entity, this would include, but not be limited to:

- Funding of additional equity.
- Commencement of additional activities (e.g., entering a subsequent “phase” of development).

**Example 5-17**

Entity D is a development-stage entity. Investor A and Investor B each contributed $1 million of equity financing to D. Entity D’s current activities consist of product development and marketing surveys (“phase I”). Upon successful completion of phase I, D plans to commence test marketing (i.e., selling these products in selected areas) (“phase II”). During the final phase of D’s development stage, it plans to engage in limited-scale production and selling efforts (“phase III”). Entity D’s by-laws allow A and B to fund additional equity upon the completion of phase I and phase II. However, it is not certain that D will proceed to phase II.

In the assessment of whether D has sufficient equity at risk under ASC 810-10-15-14(a), only the current phase of D’s development needs to be considered. Thus, if, at inception, the $2 million of equity capital is deemed sufficient to finance phase I, D would be considered to have sufficient equity investment at risk. This determination should be reassessed at the commencement of phase II and phase III, upon the funding of additional equity financing, or upon the occurrence of any of the events in ASC 810-10-35-4.

### 5.3 Equity Investors, as a Group, Lack the Characteristics of a Controlling Financial Interest

A reporting entity determines whether it holds a controlling financial interest in a legal entity differently under the VIE model than it does under the voting interest entity model. The voting interest entity model focuses on the voting rights conveyed by equity interests. Since the holder of an interest other than equity may control the legal entity, the voting interest entity model may not yield an appropriate consolidation conclusion if the equity interests at risk collectively do not possess the characteristics that are typical of equity interests. Accordingly, a legal entity is considered a VIE if the at-risk holders as a group, through their equity investment at risk, lack any of the following three qualities, which are the “typical” characteristics of an equity investment:

- The power to direct the most significant activities of the legal entity (see Section 5.3.1).
- The obligation to absorb the expected losses of the legal entity (see Section 5.3.2).
- The right to receive the expected residual returns of the legal entity (see Section 5.3.3).
The rights of the equity investor group must be a characteristic of the equity investment at risk itself and not a characteristic of other interests held by the current holders of the equity investment at risk. For example, an interest outside the equity investment at risk may permit its holder to direct the most significant activities of the legal entity. If that substantively separate interest is held by a party that is also an owner of equity investment at risk, it should not be combined with the equity investment at risk in this analysis because by design, the rights and obligations do not inure to the equity interest itself. See Section 5.3.1.1.2.

Each individual equity investment at risk need not possess all three characteristics, but the total equity investment at risk must possess them all. By implication, as long as the group of equity investors possesses these three characteristics through their equity investment at risk, the failure of any one at-risk equity investor to possess the characteristics would not make the legal entity a VIE.

The following are situations (not all-inclusive) in which a legal entity is a VIE because the at-risk equity investors lack one or more of the three characteristics:

1. Holders of variable interests other than equity investment at risk (e.g., debt holders, providers of guarantees, counterparties on derivative transactions that represent variable interests, providers under service contracts that represent variable interests) have sufficient voting rights or contractual rights to prevent the holders of the equity “at risk” from having the power to direct the activities of the entity that most significantly affect the legal entity’s economic performance.

2. Holders of variable interests other than equity investment at risk protect the equity investment at risk from expected losses or cap the return on the equity investment at risk.

3. Holders of equity that is not considered at risk have the power to direct the activities of the legal entity (or a single party and its related parties hold substantive participating rights over those decisions).

**Example 5-18**

The financing of Entity 1 consists of $100 million in equity investment at risk (two investors each hold $50 million of the at-risk equity) and $200 million in convertible debt held by a single unrelated investor. The convertible debt carries 66 percent of the voting rights on all matters subject to shareholder vote (including those activities that most significantly affect the entity’s economic performance). Because the convertible debt is not considered equity at risk, and the convertible debt holder can exercise power through voting on the activities that most significantly affect the entity’s economic performance, the holders of equity investment at risk, as a group, fail to possess the power-to-direct characteristic in ASC 810-10-15-14(b)(1) through their equity investment at risk (see Section 5.3.1). Therefore, Entity 1 is a VIE.
5.3.1 The Power to Direct the Most Significant Activities of the Legal Entity

ASC 810-10

15-14 A legal entity shall be subject to consolidation under the guidance in the Variable Interest Entities Subsections if, by design, any of the following conditions exist. (The phrase by design refers to legal entities that meet the conditions in this paragraph because of the way they are structured. For example, a legal entity under the control of its equity investors that originally was not a VIE does not become one because of operating losses. The design of the legal entity is important in the application of these provisions.) . . .

b. As a group the holders of the equity investment at risk lack any one of the following three characteristics:

1. 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.
   i. For legal entities other than limited partnerships, investors lack that power through voting rights or similar rights if no owners hold voting rights or similar rights (such as those of a common shareholder in a corporation). Legal entities that are not controlled by the holder of a majority voting interest because of noncontrolling shareholder veto rights (participating rights) as discussed in paragraphs 810-10-25-2 through 25-14 are not VIEs if the holders of the equity investment at risk as a group have the power to control the entity and the equity investment meets the other requirements of the Variable Interest Entities Subsections.
   01. If no owners hold voting rights or similar rights (such as those of a common shareholder in a corporation) over the activities of a legal entity that most significantly impact the entity's economic performance, kick-out rights or participating rights (according to their VIE definitions) held by the holders of the equity investment at risk shall not prevent interests other than the equity investment from having this characteristic unless a single equity holder (including its related parties and de facto agents) has the unilateral ability to exercise such rights. Alternatively, interests other than the equity investment at risk that provide the holders of those interests with kick-out rights or participating rights shall not prevent the equity holders from having this characteristic unless the fees paid to the decision maker represent a variable interest based on paragraphs 810-10-55-37 through 55-38.
   ii. For limited partnerships, partners lack that power if neither (01) nor (02) below exists. The guidance in this subparagraph does not apply to entities in industries (see paragraphs 910-810-45-1 and 932-810-45-1) in which it is appropriate for a general partner to use the pro rata method of consolidation for its investment in a limited partnership (see paragraph 810-10-45-14).
   01. A simple majority or lower threshold of limited partners (including a single limited partner) with equity at risk is able to exercise substantive kick-out rights (according to their voting interest entity definition) through voting interests over the general partner(s).
   A. For purposes of evaluating the threshold in (01) above, a general partner's kick-out rights held through voting interests shall not be included. Kick-out rights through voting interests held by entities under common control with the general partner or other parties acting on behalf of the general partner also shall not be included.
   02. Limited partners with equity at risk are able to exercise substantive participating rights (according to their voting interest entity definition) over the general partner(s).
   03. For purposes of (01) and (02) above, evaluation of the substantiveness of participating rights and kick-out rights shall be based on the guidance included in paragraphs 810-10-25-2 through 25-14C. . . .

If interests other than the equity investment at risk provide the holders of that investment with these characteristics or if interests other than the equity investment at risk prevent the equity holders from having these characteristics, the entity is a VIE. . . .
A legal entity can be structured to give a number of different involved parties the ability to make decisions related to the legal entity (e.g., the equity holders, the holders of interests other than equity such as debt, or a decision maker). For legal entities other than limited partnerships, a legal entity would be considered a VIE (regardless of the sufficiency of the equity investment at risk) if an interest or party outside the equity investment at risk is making the decisions that most significantly affect the legal entity’s economic performance. A limited partnership or similar entity would be considered a VIE unless the limited partners hold substantive kick-out or participating rights.

The legal form of a legal entity (e.g., corporation, partnership, LLC) can affect its governance and, accordingly, which party has the ability to make decisions. Generally, a legal entity structured as a limited partnership is required by applicable partnership law to have a general partner responsible for governing the limited partnership and has, by its nature, a decision maker. By contrast, other legal entities, such as corporations, have equity holders that generally make decisions, even if those decisions are delegated to another party. Accordingly, the determination of whether the equity holders, as a group, have the power to direct the most significant activities of a legal entity is based on the entity’s legal form. Possession of the “power to direct” characteristic is assessed differently depending on whether the legal entity is a limited partnership (or similar entity) or any other type of legal entity. See Section 5.3.1.2.1 for a discussion of what is meant by a “similar entity.”

As noted above, if participating rights are held by an interest or party outside the equity investment at risk, a legal entity would be considered a VIE. The legal form of the legal entity, however, governs which definition of participating rights (i.e., the VIE definition or the voting interest entity definition) is used in the determination of whether the legal entity is a VIE or voting interest entity. If the legal entity is an entity other than a limited partnership, the VIE definition is used. As discussed in Section 5.3.1.1.3.5, the analysis for a legal entity other than a limited partnership focuses on whether participating rights are related to the most significant activities, while the analysis for a limited partnership (or similar entity) focuses on whether the rights are related to decisions made in the ordinary course of business (see Section 5.3.1.2.7 for further discussion).

Note that for limited partnerships and entities other than limited partnerships, different definitions of participating rights are not used in the identification of the primary beneficiary of a VIE; rather, the VIE definition of participating rights applies to both types of legal entities. Accordingly, the primary-beneficiary analysis focuses on whether the participating rights are related to the activities that most significantly affect the VIE’s economic performance (see Section 7.2.10.4 for further discussion).
5.3.1.1 The Power to Direct the Most Significant Activities of an Entity Other Than a Limited Partnership (or Similar Entity)

ASC 810-10

15-14 A legal entity shall be subject to consolidation under the guidance in the Variable Interest Entities Subsections if, by design, any of the following conditions exist. (The phrase by design refers to legal entities that meet the conditions in this paragraph because of the way they are structured. For example, a legal entity under the control of its equity investors that originally was not a VIE does not become one because of operating losses. The design of the legal entity is important in the application of these provisions.) . . .

b. As a group the holders of the equity investment at risk lack any one of the following three characteristics:

1. 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.

i. For legal entities other than limited partnerships, investors lack that power through voting rights or similar rights if no owners hold voting rights or similar rights (such as those of a common shareholder in a corporation). Legal entities that are not controlled by the holder of a majority voting interest because of noncontrolling shareholder veto rights (participating rights) as discussed in paragraphs 810-10-25-2 through 25-14 are not VIEs if the holders of the equity investment at risk as a group have the power to control the entity and the equity investment meets the other requirements of the Variable Interest Entities Subsections.

01. If no owners hold voting rights or similar rights (such as those of a common shareholder in a corporation) over the activities of a legal entity that most significantly impact the entity’s economic performance, kick-out rights or participating rights (according to their VIE definitions) held by the holders of the equity investment at risk shall not prevent interests other than the equity investment from having this characteristic unless a single equity holder (including its related parties and de facto agents) has the unilateral ability to exercise such rights. Alternatively, interests other than the equity investment at risk that provide the holders of those interests with kick-out rights or participating rights shall not prevent the equity holders from having this characteristic unless a single reporting entity (including its related parties and de facto agents) has the unilateral ability to exercise those rights. A decision maker also shall not prevent the equity holders from having this characteristic unless the fees paid to the decision maker represent a variable interest based on paragraphs 810-10-55-37 through 55-38. . . .

If interests other than the equity investment at risk provide the holders of that investment with these characteristics or if interests other than the equity investment at risk prevent the equity holders from having these characteristics, the entity is a VIE. . . .

The evaluation of whether the at-risk equity holders, as a group, have power to direct the most significant activities of a legal entity other than a limited partnership (or similar entity) focuses on whether the voting rights or similar rights of the at-risk holders’ equity investment at risk allow them to direct the activities that most significantly affect the legal entity’s economic performance. In making this determination, the reporting entity would:

• Identify the group of equity investors that has equity investment at risk (see Section 5.2). If an equity investor has inconsequential equity (e.g., less than 1 percent of the outstanding equity) but has been granted decision-making rights, that investor would generally not be considered part of the group of equity investors at risk.

• Identify the most significant activities that affect the economic performance of the legal entity (see Section 5.3.1.1.1).

• Evaluate whether, as a group, the equity investors at risk unilaterally have the power over all of the most significant activities through their equity interest itself (i.e., not through a substantively separate management contract or other interest in the entity — see Section 5.3.1.1.2).
• If there is an outsourced decision maker (whether through a substantively separate arrangement with an equity investor or an unrelated third party), determine whether (1) the decision maker's rights represent a variable interest, (2) a single equity investor at risk (including its related parties) holds a substantive kick-out right to remove the decision maker, or (3) a single equity investor at risk (including its related parties) has the right to participate in the most significant activities of the entity.

The legal entity is a VIE if the above analysis demonstrates that a variable interest holder that does not hold equity investment at risk (or obtains its rights through a substantively separate contract) directs the most significant activities of the legal entity or a single party outside the group of at-risk equity investors substantially participates in the most significant activities (see Section 5.3.1.1.3.1).

5.3.1.1.1 Identifying the Most Significant Activities (Including Predetermined Activities)

The assessment of whether the reporting entity has the power to direct the most significant activities is consistent with the assessment performed later in the consolidation analysis to identify whether the reporting entity satisfies the primary-beneficiary power condition over a VIE (see Section 7.2). The reporting entity must carefully consider the design and purpose of the legal entity. In addition, unlike the analysis generally performed under the voting interest entity model, under the VIE analysis the reporting entity cannot assume that the operating, capital, and financing decisions or the hiring and firing of management or setting of management's compensation are the legal entity's most significant activities. The reporting entity must identify the level at which the entity's most significant decisions are made. For example, certain decisions may be made by the board of directors, while others may be made by another party (e.g., a decision maker through a contract that is substantively separate from the equity interests). If decisions about the most significant activities are made by the board of directors (which would be the case for most operating entities), a decision maker would effectively be acting as a service provider on behalf of the board of directors. See Section 7.2.5 for a discussion of the determination of whether the most significant activities are performed at the board level or at the manager level.

The reporting entity should also understand the purpose and design of the legal entity, including the risks that the legal entity was designed to create and pass through to the variable interest holders. Once the risks of the legal entity that affect its economic performance are identified, the reporting entity should evaluate the activities that are expected to have the most significant impact on the economic performance of the legal entity and the types of decisions that can be made regarding those activities, including significant decisions made in directing and carrying out the legal entity's current business activities. Generally, activities related to managing the risks the legal entity was designed to pass along to the variable interest holders are the key activities that affect the economic performance. As part of this analysis, it is important for the reporting entity to distinguish between the ability (1) to make significant decisions that are expected to be made in the ordinary course of carrying out the legal entity's current business activities and (2) to make decisions in exceptional circumstances or to veto or prevent certain fundamental changes in the legal entity's design or activities. The latter are generally considered protective rights.

In limited situations, the ongoing activities performed throughout the life of a legal entity (e.g., administrative activities in certain resecuritization entities, such as Re-REMICs3) do not significantly affect the legal entity's economic performance, though they may be necessary for the legal entity's continued existence (see Section 7.2.3.2 for information about which party, if any, should consolidate a VIE with no ongoing activities). In such cases, the equity investment at risk would not possess the power to direct

3 Re-REMICs are resecuritizations of real estate mortgage investment conduit securities.
the most significant activities of the entity unless the holders of the equity investment at risk have (1) the unilateral ability to change the governing documents or contractual arrangements without the approval of other parties, such as lenders, and (2) the right to change the governing documents or contractual arrangements is integral to the design of the entity. If the equity holders have this unilateral ability, the right to change the governing documents or contractual arrangements is integral to the design of the entity, and these activities are the most significant activities, the equity holders would possess the power.

**Example 5-19**

A trust has been established to issue beneficial interests (including equity investment at risk) to investors. These interests are backed by a pool of mortgage-backed securities (MBS) that were identified and purchased at the trust's inception. The holders of the trust's beneficial interests are entitled to the cash flows from the underlying MBS if and when those cash flows are received by the trust. ServicerCo, the servicer of the trust, performs activities that are solely administrative (e.g., it collects cash flows from the securities and passes the cash flows to the holders of the beneficial interests); it neither actively manages the portfolio of MBS nor performs any risk-mitigation activities (e.g., activities related to credit defaults on the MBS). The trust is prohibited from disposing of or acquiring any securities, regardless of future events; and the MBS themselves do not provide their holder (i.e., the trust) with any decision-making (i.e., voting or other) rights. Neither ServicerCo nor the holders of the trust's beneficial interests have the ability to change the governing documents of the trust. All of the significant decisions related to the trust have been specified in the trust's creation documents, which cannot be unilaterally altered by either ServicerCo or the holders of the trust's beneficial interests. The ongoing activities performed throughout the life of the trust do not significantly affect the entity's economic performance, though they may be necessary for the trust's continued existence. Therefore, the group of holders of the trust's equity investment at risk does not possess the ability to make decisions, and the trust is a VIE.

5.3.1.1.2 Determining Whether Decision-Making Rights Are Substantively Separate From an Equity Investment at Risk

In certain circumstances, an equity holder may own equity investment at risk and another substantively separate interest that gives that party the power to direct the most significant activities of the legal entity. If the power to direct the most significant activities is provided to the holder by embedding it in any variable interest of a legal entity other than the equity investment at risk, the legal entity is a VIE. However, if the power is through a decision-making contract that is determined not to be a variable interest, the legal entity is not a VIE under ASC 810-10-15-14(b)(1)(i).

**Example 5-20**

Assume that a legal entity is formed by the issuance of equity investment at risk and debt, both with voting rights proportional to the amount invested. Investor 1 contributes $20 in return for equity with a 20 percent vote. Investor 2 contributes $80 — $20 for equity with a 20 percent vote, and $60 for debt with a 60 percent vote. Decisions are based on a simple majority of all voting rights.

Although the holders of equity investment at risk have, as a group, the power to direct, the equity investment at risk does not convey the power to direct the activities of the legal entity that most significantly affect the legal entity's economic performance. That conclusion is reached because 60 percent of the voting rights are attached to investor 2's debt instrument. The voting ability attached to the debt is so significant that it prevents the equity from possessing the power to direct. Therefore, the legal entity would be a VIE.

Alternatively, if Investor 2 contributes $80 — $60 for equity with a 60 percent vote, and $20 for debt with a 20 percent vote, the legal entity would not be a VIE under this criterion because the equity investment at risk conveys to the equity holders as a group the power (i.e., an 80 percent majority vote) to direct the activities of the legal entity that most significantly affect the legal entity's economic performance.
Example 5-21

Assume that a legal entity is formed by two investors: Investors A and B. Investor A has equity investment at risk, but B does not. All of the most significant activities of the legal entity require the consent of both investors.

Although the equity investors, as a group, control the legal entity, B is not in the group of equity investors at risk. Therefore, the legal entity is a VIE because A, the only equity investor at risk, does not possess the power to direct the most significant activities.

It may be difficult to determine where power resides when an equity investor at risk separately holds decision-making rights over a legal entity through an interest other than equity. Although the discussion below is in the context of a management agreement, the concepts apply to any interests other than equity investment at risk that possess decision-making rights. The reporting entity must determine whether the decision-making rights that are derived from the separate management arrangement are substantively separate from the decision maker’s equity investment at risk.

The determination of whether a management agreement is substantively separate from an equity investment at risk should take into account all relevant facts and circumstances, including the form and substance of the pertinent arrangements. If the decision maker must maintain an equity investment at risk to retain its decision-making rights under the management agreement, the management agreement and the equity investment at risk would generally not be considered substantively separate. If, however, the decision maker is not required to maintain an equity investment at risk to retain its decision-making rights under the management agreement, the management agreement and the equity investment at risk would generally be considered substantively separate.

The legal entity’s formation documents may be silent about whether the decision maker is required to maintain an equity investment at risk to retain its decision-making rights under the management agreement. If so, the management agreement should be presumed to be substantively separate from the equity investment at risk unless other facts and circumstances provide persuasive evidence to the contrary. Other facts and circumstances that may be relevant include consent rights. For example, there may be sufficient evidence that the management agreement and equity investment at risk are not substantively separate if (1) the other equity investors at risk must provide their consent before the decision maker is allowed to transfer (dispose of) its equity interests while retaining its decision-making rights under the management agreement and (2) such a consent requirement is substantive.

The evaluation of whether a management agreement is substantively separate from an equity investment at risk focuses on whether the existing decision maker is required to hold an equity investment at risk in the legal entity to retain its decision-making rights under the management agreement. A reporting entity should consider the following factors:

- Whether the reporting entity with decision-making rights under the management agreement must maintain an equity investment at risk in the legal entity — In some cases, the contractual agreements pertaining to the legal entity may permit the reporting entity with decision-making rights to transfer its management agreement to a third party (or an existing equity investor in the legal entity) and still maintain its equity investment in the legal entity. This does not necessarily mean that the group of holders of equity investment at risk lacks the power to direct the activities that most significantly affect the economic performance of the legal entity. For

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In these specific circumstances, a consent requirement is not substantive unless the other investors of at-risk equity are able to withhold their consent without limitation. Accordingly, consent that cannot be unreasonably withheld is generally not substantive. However, such a conclusion regarding the determination of whether a consent that cannot be unreasonably withheld is substantive should not be applied to other situations, including the evaluation of whether a noncontrolling interest holder has substantive participating rights, as discussed in Section D.2.3. A consent requirement may also not be substantive if the other equity investors are related parties or de facto agents of the decision maker.
example, if the contractual agreements permit the decision maker to transfer its management agreement only to a third party (or existing equity investor in the legal entity) that has an equity investment at risk in the legal entity, the group of equity investors at risk would have the power to direct the activities that most significantly affect the economic performance of the legal entity.

- **Whether the management agreement is considered a freestanding contract or embedded in the equity investment at risk under other applicable U.S. GAAP** — While the form and substance of the arrangements must be evaluated, the objective of the evaluation under ASC 810-10-15-14(b)(1) is not to determine whether the management agreement is a freestanding contract. For example, if the decision maker can transfer the management agreement only to an equity investor at risk while still maintaining its equity investment in the legal entity, the management agreement would typically be considered a freestanding contract under other applicable U.S. GAAP.

However, since it must be determined whether the decision maker has the ability to transfer the management agreement to a third party that does not own an equity investment at risk in the legal entity, a conclusion that the management agreement is a freestanding contract under other applicable U.S. GAAP does not necessarily mean that the power to direct the activities that most significantly affect the economic performance of the legal entity does not reside with the equity investors at risk as a group.

- **Whether the legal entity has multiple classes of equity investment at risk** — A legal entity may have more than one class of equity investment at risk. Since ASC 810-10-15-14(b)(1) focuses on the group of holders of equity investment at risk, it must be determined whether the decision maker is required to maintain an equity investment at risk (as opposed to a specific class of equity investment at risk) to retain the management agreement. For example, if the decision maker must maintain an equity investment at risk to retain its decision-making rights under the management agreement, but the class of equity investment at risk is not specified (or could change), the management agreement and equity investment at risk are still not considered substantively separate.

- **Whether the legal entity’s formation documents address whether a replacement decision maker is required to maintain an equity investment at risk** — The terms and agreements of the legal entity may specify that any decision maker under a management agreement must also own an equity investment at risk in the legal entity. In these situations, the management agreement and equity investment at risk are unlikely to be considered substantively separate; therefore, the group of holders of equity investment at risk would not lack the power to direct the activities that most significantly affect the economic performance of the legal entity. In other situations, the terms and agreements of the legal entity may not specifically address whether a replacement decision maker is required to own an equity investment at risk. In these situations, the evaluation should focus on whether the current decision maker is required to maintain an equity investment at risk in the legal entity. However, a transfer of the management agreement to a party that does not hold equity investment at risk would represent a reconsideration event under ASC 810-10-35-4. This treatment is consistent with that of a situation in which the equity investors at risk choose not to require a replacement decision maker to own an equity investment at risk even though the legal entity’s formation documents specifically require any decision maker to own such an equity investment. In both situations, the change represents a reconsideration event under ASC 810-10-35-4.
5.3.1.1.3 Determining Whether the Equity Holders Have Power Over a Legal Entity When a Decision Maker Is Engaged

Assessing whether the equity holders, as a group, have the power to direct the most significant activities of a legal entity other than a limited partnership (or similar entity) can be difficult when the power over a legal entity is acquired through a management agreement. The flowchart below illustrates how to assess whether the equity investors at risk have power over a legal entity when a decision maker is engaged:

5.3.1.1.3.1 Does the Decision Maker Have a Variable Interest in the Legal Entity?

If it is determined that a decision maker exists, an evaluation of whether the decision maker has a variable interest in the legal entity must be performed. If there is no decision maker, the equity holders must perform step 1 in the flowchart above (and consider the general principles in Section 5.3.1.1) to determine whether the equity investors at risk have the collective power to direct the most significant activities of the legal entity through their equity investment at risk.

Although participating rights must also be considered, as discussed in Section 5.3.1.1.3.5, we do not believe that such rights have the same impact on the VIE determination as kick-out rights in this context.
However, the mere existence of a decision maker in a legal entity does not mean that the holders of equity investment at risk as a group do not have the power to direct that legal entity's most significant activities through their equity investment at risk. The equity holders may engage a decision maker to perform certain services on their behalf but retain ultimate responsibility for and power over decision making. In other words, when the decision maker is a fiduciary of the investors, it is presumed that the equity holders, as a group, have the power to direct the most significant activities of the legal entity.

If a decision maker's fee arrangement does not constitute a variable interest, the decision maker's power to direct the activities is effectively attributed to the investors. That is, the decision maker does not prevent the equity investors at risk, through their equity investment at risk, from possessing the power over the entity because the decision maker is deemed to be acting as a fiduciary (i.e., making decisions on behalf of others). In many cases, it will be easier to conclude that the decision maker’s fee is not a variable interest (and therefore that the power rests with the holders of equity investment at risk) than to perform the two-step evaluation outlined in the flowchart above. Accordingly, a reporting entity may be able to conclude that the legal entity meets the criterion in ASC 810-10-15-14(b)(1) simply because the decision maker's fee arrangement is not a variable interest. See Section 4.4 for a discussion of whether decision-maker fees represent a variable interest.

5.3.1.1.3.2  Determine Whether the Equity Holders Have Power Through Their Equity Investment at Risk (Step 1)

If a decision maker has a variable interest in a legal entity, the reporting entity must next identify the level at which the legal entity's most significant decisions are made. For example, certain decisions may be made by the board of directors, while others may be made by a decision maker through a contract that is substantively separate from the equity interests. If decisions about the most significant activities are made by the board of directors (which would be the case for most operating entities), the decision maker would effectively be acting as a service provider on behalf of the board of directors. See Section 7.2.5 for additional discussion of the determination of whether the most significant activities are performed at the board level or at the manager level. Paragraph BC35 of ASU 2015-02 discusses such circumstances:

This may be the case, for example, when the equity holders' voting rights provide them with the power to elect the entity's board of directors and the board is actively involved in making decisions about the activities that most significantly impact the entity's economic performance. The equity holders may have power through voting rights in their equity-at-risk interests over the activities of a legal entity that most significantly impact the entity's economic performance even if the entity has a decision maker.

If a reporting entity concludes that the most significant activities of the legal entity are directed by the decision maker (and not by the board of directors), the equity holders would not have the power to direct the most significant activities unless the equity holders as a group have the ability to remove and set the compensation of the decision maker. The example in ASC 810-10-55-8A though 55-8H indicates that “the activities that most significantly impact the economic performance of Fund A, which include making decisions on how to invest the assets of that fund, are carried out by the asset management company.” In that example, the most significant activities of the legal entity are directed by the decision maker and not conducted at the board-of-director level. However, the FASB concludes in the example that the entity’s shareholders are able to effectively direct those activities through their voting rights “because shareholders have the ability to directly remove and replace the asset management company, approve the compensation of the asset management company, and vote on the investment strategy of Fund A.”
Conversely, if decisions about the most significant activities are made by the board of directors, the decision maker would effectively be acting as a service provider on behalf of the board of directors. In addition, the board of directors is typically merely an extension of the legal entity’s equity holders established to act solely in a fiduciary capacity for the equity holders. However, this may not always be the case. For example, the board of directors may have been elected by the debt investors or parties other than the equity investors. If the board of directors is not considered to be acting on behalf of the holders of equity investment at risk, such holders do not have the power to direct the most significant activities of a legal entity. Rather, the party that elected the board of directors may have such rights.

5.3.1.1.3.3 Application to a Series Trust

ASC 810-10-55-8A through 55-8F provide the following example of the step 1 assessment:

**ASC 810-10**

**55-8A** An asset management company creates a series fund structure in which there are multiple mutual funds (Fund A, Fund B, and Fund C) within one (umbrella) trust. Each mutual fund, referred to as a series fund, represents a separate structure and legal entity. The asset management company sells shares in each series fund to external shareholders. Each series fund is required to comply with the requirements included in the Investment Company Act of 1940 for registered mutual funds.

**55-8B** The purpose, objective, and strategy of each series fund are established at formation and agreed upon by the shareholders in accordance with the operating agreements. Returns of each series fund are allocated only to that respective fund’s shareholders. There is no cross-collateralization among the individual series funds. Each series fund has its own fund management team, employed by the asset management company, which has the ability to carry out the investment strategy approved by the fund shareholders and manage the investments of the series fund. The Board of Trustees is established at the (umbrella) trust level.

**55-8C** The asset management company is compensated on the basis of an established percentage of assets under management in the respective series funds for directing the activities of each fund within its stated objectives. The fees paid to the asset management company are both of the following:

- a. Compensation for services provided and commensurate with the level of effort required to provide the services
- b. Part of service arrangements that include only terms, conditions, or amounts that are customarily present in arrangements for similar services negotiated at arm's length.

**55-8D** The asset management company has sold 65 percent of the shares in Fund A to external shareholders and holds the remaining 35 percent of shares in Fund A.

**55-8E** The shareholders in each series fund have the ability through voting rights to do the following:

- a. Remove and replace the Board of Trustees
- b. Remove and replace the asset management company
- c. Vote on the compensation of the asset management company
- d. Vote on changes to the fundamental investment strategy of the fund
- e. Approve the sale of substantially all of the assets of the fund
- f. Approve a merger and/or reorganization of the fund
- g. Approve the liquidation or dissolution of the fund
- h. Approve charter and bylaw amendments
- i. Increase the authorized number of shares.
For this series fund structure, the voting rights in paragraph 810-10-55-8E(a) are exercised at the (umbrella) trust level. That is, a simple majority vote of shareholders of all of the series funds (Fund A, Fund B, and Fund C) is required to exercise the voting right to remove and replace the Board of Trustees of the (umbrella) trust. However, the voting rights in paragraph 810-10-55-8E(b) through (i) are series fund-level rights. That is, only a simple majority vote of Series Fund A’s shareholders is required to exercise the voting rights in paragraph 810-10-55-8E(b) through (i) for Series Fund A.

In the example in ASC 810-10-55-8A through 55-8F, it is concluded that the equity investors (rather than the investment manager through its decision-making contract) have power through their voting rights because of their ability to constrain the decision maker’s authority. Accordingly, as long as the other conditions in ASC 810-10-15-14 are met, the entity would not be a VIE.

Further, the example indicates that the rights afforded to the equity investors of a series fund structure that operates in accordance with the 1940 Act would typically give the shareholders the ability to direct the activities that most significantly affect the fund’s economic performance through their equity interests. While these rights are often given to the investors of a fund structure that is regulated under the 1940 Act, they are less likely to be present in fund structures established in foreign jurisdictions (particularly those established in a structure similar to a series structure) or in domestic funds that do not operate in accordance with the requirements of the 1940 Act. See Section 3.2.1 for an additional discussion of series funds.

Although the example illustrates the evaluation for a legal entity that is regulated under the 1940 Act, it does not apply exclusively to such entities. The FASB clarifies in paragraph BC36 of ASU 2015-02 that “the Board does not intend for the two-step analysis described above to apply only to series mutual funds.”

Reporting entities will need to exercise considerable judgment in determining whether the equity investors at risk have power through their voting rights. Understanding the rights and responsibilities of each involved party, and the design of the legal entity itself, is critical in such a situation.

**5.3.1.1.3.4 Determine Whether a Single Equity Owner Has a Substantive Kick-Out Right (Step 2)**

If a reporting entity determines that the decision-making rights represent a variable interest and that the decision maker (rather than the equity investors) have power over the significant decisions (step 1), the reporting entity would then assess whether a single equity holder through its equity investment at risk (including its related parties and de facto agents — see Section 8.2) has the unilateral ability to remove the decision maker. ASC 810-10-20 provides the following VIE definition of kick-out rights:

> The ability to remove the entity with the power to direct the activities of a VIE that most significantly impact the VIE’s economic performance or to dissolve (liquidate) the VIE without cause.

If a single at-risk equity investor has the ability, through its equity investment at risk, to unilaterally remove the decision maker (or dissolve/liquidate the legal entity), then that single equity owner has the power to direct the activities and, accordingly, the equity group at risk would have the unilateral ability to direct the most significant activities. Said differently, in such a case, the decision maker is making decisions on behalf of the at-risk equity investors only temporarily at the discretion of the single at-risk equity investor with the kick-out rights. If such rights do not exist, the reporting entity would consider the effect of substantive participating rights held by a single equity investor (see Section 5.3.1.1.3.5).
In paragraph BC49 of ASU 2015-02, the FASB noted that liquidation rights “should be considered equivalent to kick-out rights [because they] provide the holders of such rights with the ability to dissolve the entity and, thus, effectively remove the decision maker’s authority.” See Section 5.3.1.2.5 for a discussion of when liquidation and withdrawal rights would be considered equivalent to kick-out rights.

### 5.3.1.3.5 Impact of a Single Equity Owner With Substantive Participating Rights (Step 2)

Since the FASB discusses participating rights in the same context as kick-out rights, the implication is that the two, though defined differently, should be treated similarly in the VIE analysis. We do not believe that the existence of a substantive participating right held by a single equity investor at risk should result in a conclusion that the legal entity is not a VIE. ASC 810-10-20 provides the following VIE definition of participating rights:

> The ability to block or participate in the actions through which an entity exercises the power to direct the activities of a VIE that most significantly impact the VIE’s economic performance. Participating rights do not require the holders of such rights to have the ability to initiate actions.

Further, ASC 810-10-15-14(b)(1)(i)(01) states, in part:

> If no owners hold voting rights or similar rights (such as those of a common shareholder in a corporation) over the activities of a legal entity that most significantly impact the entity’s economic performance, kick-out rights or participating rights (according to their VIE definitions) held by the holders of the equity investment at risk shall not prevent interests other than the equity investment from having this characteristic unless a single equity holder (including its related parties and de facto agents) has the unilateral ability to exercise such rights. [Emphasis added]

The phrase emphasized above specifies that if substantive kick-out or participating rights are held by a single owner of equity investment, then the equity holder would not be prevented from having the power to direct the activities that most significantly affect the VIE’s economic performance. However, it does not indicate that the equity holder with such rights has that power. While an equity holder with a kick-out right may have the power to direct the most significant activities, a conclusion is less likely to be reached that an equity holder with participating rights has the power to direct the most significant activities. That is, if a single holder of equity investment at risk can substantively participate in decisions about a legal entity that are being made by the decision maker, that decision maker does not have the power to direct the most significant activities of the legal entity (i.e., the ability of the one equity investor to participate keeps the decision maker from having the unilateral ability to act but does not give the equity investor the unilateral ability). Thus, since the guidance above indicates that the decision maker does not have power but not that the equity investors, as a group, do have power, the next sentence in ASC 810-10-15-14(b)(1)(i)(01) would need to be considered, which states, in part:

> Alternatively, interests other than the equity investment at risk that provide the holders of those interests with kick-out rights or participating rights shall not prevent the equity holders from having this characteristic unless a single reporting entity (including its related parties and de facto agents) has the unilateral ability to exercise those rights.

Accordingly, if a nonequity holder has the ability to direct the activities that most significantly affect the legal entity’s economic performance, and an equity holder has the ability to block the nonequity holder’s actions through a substantive participating right, the legal entity would still be a VIE because the equity holder would not have power over the entity. The VIE conclusion should be the same regardless of whether the equity investor at risk is initiating decisions (but could be blocked by a nonequity investor at risk) or another party is directing the most important economic activities (but could be blocked by the holder of equity investment at risk). In both instances, the legal entity would be a VIE. That is, a legal entity would be a VIE if power is distributed between (1) equity investment at risk and (2) equity investment not at risk or nonequity holders; for a legal entity to be a voting interest entity, only the holders of equity investment at risk may have power.
We therefore believe that it would be unusual for a substantive participating right held by a single at-risk equity investor alone to result in a conclusion that the equity investors as a group have the power to direct the most significant activities of a legal entity.

5.3.1.1.3.6 Franchise Agreements

A franchise agreement typically gives the franchisee equity investor(s) the right to use the franchisor’s brand name along with its associated operating policies and procedures for a period in exchange for a franchise fee. Generally, the franchisor has certain rights under the agreement to ensure that the integrity and quality of the brand is maintained. A reporting entity should therefore carefully analyze the rights granted to the franchisor to determine whether the franchisee is a VIE under ASC 810-10-15-14(b)(1). That is, the reporting entity must determine whether the rights held by the franchisor prevent the group of franchisee equity investors from having the power to direct the activities that most significantly affect the economic performance of the franchisee.

For example, a franchise agreement may specify that the franchisor has rights to participate in certain decisions related to:

- The location and appearance of the franchisee.
- Products sold by the franchisee.
- Suppliers used by the franchisee.
- Marketing by the franchisee.
- Training of employees of the franchisee.
- Days and hours of operation of the franchisee.
- Sale of the franchisee.

Decisions related to the above items may be important to the franchisee’s economic performance; however, a franchisor’s right to participate in the decisions does not automatically cause the franchisee to be a VIE under ASC 810-10-15-14(b)(1). A reporting entity should assess whether the rights are protective in nature (i.e., intended to preserve the integrity and quality of the brand name) or prevent the franchisee equity investors at risk from holding the power to direct the activities that most significantly affect the economic performance of the franchisee.

Many of a franchisee’s activities are predetermined under the franchise agreement, which typically specifies that the franchisee equity investors have voluntarily agreed to operate the franchisee according to specified policies and procedures. Therefore, in assessing whether the franchisee equity investors at risk hold the power to direct the activities that most significantly affect the franchisee’s economic performance, the reporting entity must focus on whether the franchisee equity investors at risk control the activities that are not specified in the franchise agreement. Such activities include, but are not limited to, establishing and implementing capital and operating budgets; hiring, firing, and setting the compensation of franchisee employees; and establishing pricing for franchisee products and services.

If a franchisor is taking on additional risk by providing financial support to the franchisee, the franchisor may need to be more involved in the decisions regarding the most significant activities of the franchisee. Accordingly, if a franchisor gives the franchisee financial support (e.g., through an equity investment or a loan), or the franchisee equity investors’ exposure to the economic performance of the franchisee is somehow limited, the reporting entity must carefully evaluate the franchisor’s decision-making rights to determine whether they are protective or give the franchisor control over the most significant activities of the franchisee. In such instances, the reporting entity must consider all relevant facts.
and circumstances to determine whether the franchisee is a VIE under ASC 810-10-15-14(b)(1). In addition, if a loan or a contract limits the equity investor’s exposure to the economic performance of the franchisee, the franchisee may be a VIE under ASC 810-10-15-14(a), ASC 810-10-15-14(b)(2), or ASC 810-10-15-14(b)(3).

5.3.1.2 The Power to Direct the Most Significant Activities of a Limited Partnership (or Similar Entity)

<table>
<thead>
<tr>
<th>ASC 810-10</th>
<th>15-14 A legal entity shall be subject to consolidation under the guidance in the Variable Interest Entities Subsections if, by design, any of the following conditions exist. (The phrase by design refers to legal entities that meet the conditions in this paragraph because of the way they are structured. For example, a legal entity under the control of its equity investors that originally was not a VIE does not become one because of operating losses. The design of the legal entity is important in the application of these provisions) . . .</th>
</tr>
</thead>
</table>
| | b. As a group the holders of the equity investment at risk lack any one of the following three characteristics:  
1. 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. . . .  
ii. For limited partnerships, partners lack that power if neither (01) nor (02) below exists. The guidance in this subparagraph does not apply to entities in industries (see paragraphs 910-810-45-1 and 932-810-45-1) in which it is appropriate for a general partner to use the pro rata method of consolidation for its investment in a limited partnership (see paragraph 810-10-45-14).  
01. A simple majority or lower threshold of limited partners (including a single limited partner) with equity at risk is able to exercise substantive kick-out rights (according to their voting interest entity definition) through voting interests over the general partner(s).  
A. For purposes of evaluating the threshold in (01) above, a general partner’s kick-out rights held through voting interests shall not be included. Kick-out rights through voting interests held by entities under common control with the general partner or other parties acting on behalf of the general partner also shall not be included.  
02. Limited partners with equity at risk are able to exercise substantive participating rights (according to their voting interest entity definition) over the general partner(s).  
03. For purposes of (01) and (02) above, evaluation of the substantiveness of participating rights and kick-out rights shall be based on the guidance included in paragraphs 810-10-25-2 through 25-14C . . . . |
| | If interests other than the equity investment at risk provide the holders of that investment with these characteristics or if interests other than the equity investment at risk prevent the equity holders from having these characteristics, the entity is a VIE. . . . |

A limited partnership would be considered a VIE regardless of whether it otherwise qualifies as a voting interest entity unless either of the following apply:

- A simple majority or lower threshold (including a single limited partner) of the “unrelated” limited partners (i.e., parties other than the general partner, entities under common control with the general partner, and other parties acting on behalf of the general partner) **with equity at risk** have substantive kick-out rights (including liquidation rights — see Section 5.3.1.2.2).
- The limited partners **with equity at risk** have substantive participating rights (see Section 5.3.1.2.7).

Accordingly, a limited partnership is considered a VIE unless limited partners hold substantive kick-out or participating rights. In addition to considering whether the limited partners have equity at risk, it is also necessary to consider whether the limited partner rights are possessed through the limited partner interest that is at risk rather than through a substantively separate contract (see Section 5.3.1.1.2 for a
discussion of the determination of whether a separate contract should be considered part of the equity interest at risk).

While the FASB's intent in creating an alternate approach for evaluating limited partnerships was based on their differing governance structures, the result is that if a general partner does not possess an interest in the limited partnership that is potentially significant, the general partner should not consolidate the limited partnership. Specifically, this requirement ensures that the general partner would only consolidate the limited partnership if it met the economics criterion of a controlling financial interest under the VIE model (see Section 7.3).

5.3.1.2.1 A Legal Entity That Is “Similar to a Limited Partnership”

The requirement to evaluate limited partnerships under the specific guidance on limited partnerships also applies to other legal entities that have governance structures similar to limited partnerships. Determining whether a legal entity is similar to a limited partnership is consequently an important step in the assessment of whether a legal entity is a VIE. ASC 810-10-05-3 states, in part:

Throughout this Subtopic, any reference to a limited partnership includes limited partnerships and similar legal entities. A similar legal entity is an entity (such as a limited liability company) that has governing provisions that are the functional equivalent of a limited partnership.

Accordingly, certain limited liability companies in which the managing member is the functional equivalent of a general partner, and in which the nonmanaging member or members are the functional equivalent of a limited partner, would be considered equivalent to limited partnerships and evaluated under the limited-partnership requirements. A conclusion cannot be reached that a legal entity is similar to a limited partnership merely on the basis of the existence of separate capital accounts. Any analysis of similarity should include the application of judgment and focus on the function of the legal entity, including the governance and the substance of the legal entity's board of directors.

The specific guidance on limited partnerships does not apply to either general partnerships or limited liability companies that have multiple managing members since the governing provisions of such structures are not equivalent to those of limited partnerships.

Connecting the Dots

This scope guidance is one-directional (i.e., a legal entity that is not in the form of a limited partnership can be considered “similar to a limited partnership” for consolidation analysis purposes). However, we believe that in some circumstances, the governance of a legal-form limited partnership could be more similar to that of a corporation. For example, some limited partnerships may have irrevocably changed their governance structure to that of a board elected by the limited partners. We believe that in such instances, it is more appropriate for the variable interest holders to analyze the legal entity under the corporation consolidation guidance.

Example 5-22

Investor A (managing member) and Investor B (nonmanaging member) each own 50 percent of LLC, a limited liability company. As the managing member, A makes all the decisions related to activities that most significantly affect the economic performance of LLC. On the basis of LLC’s governing provisions, A is the functional equivalent of a general partner, and B is the functional equivalent of a limited partner. Therefore, LLC is considered equivalent to a limited partnership and should be evaluated under the limited-partnership VIE requirements.
Example 5-23

Assume the same facts as in Example 5-22, except that LLC has a board of directors that is composed of four individuals (two are selected by A, and two are selected by B). The decisions related to the activities that most significantly affect the economic performance of LLC are made through a simple majority vote of the board of directors. As the managing member, A acts at the direction of the board, and its responsibilities are administrative. On the basis of LLC’s governing provisions, the decision-making ability held by the board of directors is substantive. Therefore, A is not the functional equivalent of a general partner, and LLC is not considered equivalent to a limited partnership. Consequently, LLC should not be evaluated under the limited-partnership VIE requirements.

Example 5-24

Investor A has a 40 percent equity interest in LLC and is the managing member. Investor B, Investor C, and Investor D each have a 20 percent equity interest in LLC and are nonmanaging members. As the managing member, A has the authority to act on behalf of LLC or bind LLC in any manner whatsoever, including, without limitation, entering into any agreement on behalf of LLC. Investor A is given this right through a separate management agreement because A is the only investor that has expertise in the industry that LLC operates.

In exchange for its services, A receives a fixed management fee and a performance fee. LLC also has a board of directors that is composed of four representatives (one each selected by Investor A, Investor B, Investor C, and Investor D). The decisions of the Board require unanimous consent; however, they are related to decisions made outside the ordinary course of business. As the managing member, A cannot transfer or sell its interest in the LLC without the consent of the nonmanaging members, but the nonmanaging members are not similarly constrained.

On the basis of the facts and circumstances, A is the functional equivalent of a general partner, and LLC is considered equivalent to a limited partnership. The decision-making rights held by the board of directors are deemed to be not substantive and to represent protective rights. In addition, A’s fee structure and its limitations on transferring its interest are also similar to those of a general partner given its expertise in LLC’s industry. Therefore, LLC should be evaluated under the limited-partnership VIE requirements.

5.3.1.2.2 Evaluating Kick-Out Rights

The evaluation of whether the limited partners with equity at risk can kick out the general partner focuses on whether a simple majority (or lower threshold) of the limited partner interests (excluding those held by the general partner, entities under common control with the general partner, and entities acting on behalf of the general partner) can remove the general partner. Accordingly, the kick-out rights would not be considered in the analysis unless (1) a simple majority (or lower threshold) of the limited partners can exercise the kick-out rights (or liquidation rights that are equivalent to kick-out rights, as discussed in Section 5.3.1.2.5); (2) the rights can be exercised by limited partner interests excluding those held by the general partner, entities under common control with the general partner, and entities acting on behalf of the general partner (see Section 5.3.1.2.3); and (3) the rights are substantive (see Section 5.3.1.2.4).
Example 5-25

A limited partnership is formed to acquire a real estate property. The partnership has a general partner that holds a 20 percent limited partner interest in the partnership, and eight unrelated limited partners equally hold the remaining equity interests. Profit and losses of the partnership (after payment of general partner fees, which represent a variable interest in the entity) are distributed in accordance with the partners’ ownership interests. There are no other arrangements between the partnership and the general partners/limited partners.

The general partner is the property manager and has full discretion to buy and sell properties, manage the properties, and obtain financing. In addition, the general partner can be removed without cause by a simple majority of all of the limited partners (including the limited partner interests held by the general partner). The removal rights are held by all the partners in proportion to their partnership interests.

<table>
<thead>
<tr>
<th>General Partner (Holds Limited Partner Interests)</th>
<th>Unrelated Limited Partners</th>
</tr>
</thead>
<tbody>
<tr>
<td>20%</td>
<td>80%</td>
</tr>
</tbody>
</table>

In this example, the limited partner interests held by the general partner are permitted to vote on the removal of the general partner. The general partner, through its limited partner interests, will therefore vote 20 percent of the overall interests voting on the removal. The unrelated limited partner interests only hold 80 percent of the interests voting on removal. Since the unrelated limited partners are unable to remove the general partner unless more than a simple majority of the limited partner interests vote on the removal (i.e., the general partner’s presumed no vote on removal will require 75 percent of the unrelated limited partner interests — six of the eight unrelated limited partners — to remove the general partner), the kick-out rights would not be substantive, and the limited partnership would be considered a VIE.

Note that some partnership agreements are structured so that the general partners and their “related” parties are unable to exercise the rights associated with any limited partner interests they hold. In these situations, a simple majority of the “unrelated” limited partners with equity at risk may have the ability to exercise substantive kick-out rights over the general partner, regardless of whether the general partner holds any other interests.

In the determination of whether there are simple majority kick-out rights, certain factors will be known. For example, the contractual terms will provide the mechanism for removing the general partner, and the total number of limited partner interests will be apparent. However, variables such as who the qualifying limited partners are, what makes a kick-out right substantive, and what a substantive participating right is, will need to be determined.

EITF 04-5 introduced the concept of analyzing whether a simple majority of limited partners can remove the general partner. The purpose of the analysis was to identify the smallest possible combination of limited partnership interests that is at least a simple majority. If, on the basis of the governance provisions of the limited partnership and ownership interests held by the limited partners, the number of eligible partner interests required to remove the general partner is less than this amount, then the simple-majority requirement is met. ASC 810-10-55-4N contains examples (originally from EITF 04-5) of the application of this requirement. Examples 5-26 through 5-30, which are adapted from ASC 810-10-55-4N, are intended to demonstrate its application in certain more complex structures. Note that the examples focus on the amount of limited partnership interests needed to remove the general partner, not a simple count of the number of limited partners (i.e., it would be expected that a limited partner with more ownership interests would get a weighted vote — see Example 5-30, in which the limited partners have unequal partnership interests).
Example 5-26

A limited partnership agreement includes a requirement that a simple majority of the limited partner voting interests is needed to remove the general partner. Assume that the limited partnership has three limited partners, none of which have any relationship to the general partner, and that each holds an equal amount of the limited partner voting interests (33.33 percent). Under the simple-majority requirement in the partnership agreement, a vote of no more than two of the three limited partners would be needed to remove the general partners. Accordingly, a provision that entitles any individual limited partner to remove the general partner, or a provision under which a vote of two of the limited partners is needed to remove the general partner, would meet the substantive kick-out right requirements. However, if a vote of all three limited partners is needed to remove the general partner, the right would not meet the requirements for a substantive kick-out right because the necessary vote is greater than a simple majority of the limited partner voting interests.

Example 5-27

Assume the same facts as in Example 5-26, except that there are two limited partners that each hold an equal interest. In this case, a vote of both limited partners would be required for a simple majority of the limited partner voting interests, so a provision entitling any individual limited partner to remove the general partner, or a provision under which a vote of both limited partners is needed to remove the general partner, would meet the requirements for a substantive kick-out right.

Example 5-28

Assume the same facts as in Example 5-26, except that there are 100 limited partners, and each holds an equal interest. In this case, a vote of 51 limited partners would be required for a simple majority of the limited partner voting interests, so a provision under which a vote of less than 52 limited partners is needed to remove the general partner would meet the requirements for a substantive kick-out right. However, if a vote of 52 or more limited partners is needed to remove the general partner, that provision would not meet the requirements for a substantive kick-out right because the necessary vote is greater than a simple majority of the limited partner voting interests.

Example 5-29

A limited partnership agreement includes a requirement that a vote of 66.6 percent of the limited partner voting interests is needed to remove the general partner. There are three independent limited partners that each hold an equal percentage (33.33 percent) of the limited partner voting interest. A vote of two of the three limited partners represents 66.7 percent of the limited partner voting interests, which also represents the smallest possible combination of voting interests that is at least a simple majority of the limited partner voting interests. As long as there are no barriers to the exercise of the kick-out rights, those rights in this scenario meet the simple majority requirement and therefore represent substantive kick-out rights that overcome the presumption of control by the general partner. That is, although there is a 66.6 percent requirement in the governance of the limited partnership agreement, because there are only three limited partners with equity interest, the substance of the arrangement is a simple majority (i.e., there is no substantive difference between a stated 50.1 percent or 66.6 percent requirement, because in both instances, two of the three limited partners are needed).
Example 5-30

A limited partnership agreement includes a requirement that a vote of 66.6 percent of the limited partner voting interests is needed to remove the general partners. There are three independent limited partners that hold 45 percent (LP1), 25 percent (LP2), and 30 percent (LP3) of the limited partner voting interests, respectively. To determine whether kick-out rights are substantive in such a scenario, the reporting entity should identify the smallest possible combination of limited partner interests that constitutes a simple majority. To remove the general partners, a vote of LP1 in combination with either LP2 or LP3 would be a simple majority of the limited partners and would satisfy the 66.6 percent contractual requirement. By contrast, a vote to exercise the kick-out rights by LP2 and LP3 also would represent a simple majority vote of the limited partners. However, their voting interests (55 percent) would not meet the required threshold of 66.6 percent for removal of the general partners. Accordingly, these kick-out rights would be assessed as nonsubstantive because LP2 and LP3, which represent at least a simple majority of the limited partner voting interests, cannot remove the general partners.

The above conclusion applies even though a vote of LP1 in combination with either LP2 or LP3 would be a simple majority of the limited partners and would satisfy the 66.6 percent contractual requirement. This is because the analysis is premised on whether the smallest possible combination of limited partner interests that constitutes a simple majority that would be able to remove the general partners, not on whether any possible combination of limited partner interests that is a simple majority would be able to remove the general partners.

5.3.1.2.3 Whether Limited Partners Are “Acting on Behalf of the General Partner”

In the evaluation of whether a simple majority of the limited partners can remove the general partner, interests held by the general partner, entities under common control with the general partner, and parties acting on behalf of the general partner should not be considered in the identification of the number of limited partner interests needed to remove the general partner. If the general partner owns limited partnership interests, it is not reasonable to expect the general partner to tender a vote to remove itself. Accordingly, if in theory the general partner owns 45 percent of the limited partnership units, and a 51 percent vote is required to remove the general partner, it can be assumed that the 45 percent of limited partner interests owned by the general partner will vote no. Therefore, the relevant percentage required to remove the general partner is much higher than 51 percent: all but 4 percent of the total limited partner units must vote yes.

Thus, interests should be identified that are attributable to the general partner, or that, because of relationships, would otherwise vote along with the general partner. Identifying interests owned by the general partner is relatively straightforward. In addition, BC69 of ASU 2015-02 notes that:

Current GAAP uses the term common control in multiple contexts, and the term is not defined in the Master Glossary. Therefore, for purposes of evaluating the criteria in paragraphs 810-10-25-42, 810-10-25-44A, and 810-10-55-37D, the Board’s intent was for the term to include subsidiaries controlled (directly or indirectly) by a common parent, or a subsidiary and its parent.

This explanation does not specifically refer to the assessment of whether a limited partnership is a VIE. Nonetheless, it is reasonable to conclude that the application of the common control definition should be consistent throughout the consolidation analysis.

However, considerable judgment is required in the determination of whether a limited partner is acting on behalf of the general partner. Although now superseded, ASC 810-20-25-8(a) indicated that all “relevant facts and circumstances shall be considered in assessing whether other parties, including, but not limited to, those defined as related parties in Topic 850, may be acting on behalf of the general partners in exercising their voting rights as limited partners.”
The following are examples of relevant facts and circumstances to be considered in the evaluation of whether a limited partner is acting on behalf of the general partner:

- The design of the partnership, including:
  - The risks that the partnership was designed to pass on to its variable interest holders.
  - The reason the limited partner holds its interest in the partnership.

- The nature of the relationship(s) between the general partner and the limited partner, including:
  - The degree of influence the general partner has over the limited partner.
  - Any investment the limited partner has in the general partner. For example, if the limited partner has a material investment in a general partner, and removal of the general partner would adversely affect its investment, the limited partner might be acting on behalf of the general partner.
  - Any dependencies the limited partner has on the general partner.
  - Other operating or financial arrangements between the parties.

- The existence of any call options between the general partner and limited partner, including:
  - The terms of the option, the exercise price, and exercise period. For example, if the limited partner's interest can be purchased at fair value or less, the limited partner may be acting on behalf of the general partner.
  - The existence of any barriers to exercising the option. For example, the general partner controls technology that is critical to the limited partnership, or the general partner is the principal source of funding for the limited partnership.

- Whether the limited partner's exercise of its right to vote to remove the general partner would trigger significant financial penalties or other operating barriers.

- Any incentives or disincentives that may affect the likelihood that the limited partner would act in accordance with the general partner.

- Any regulatory, contractual, or other requirements that may affect the limited partner's ability to vote to remove the general partner. For example, a related-party limited partner's charter or organizational documents may require an independent person (or committee of independent persons) to exercise any right to vote to retain or remove the general partner.

### 5.3.1.2.4 “Substantive” Kick-Out Rights

For a kick-out right to be substantive, the right must be exercisable “without cause” (as opposed to a right that is triggered upon a contingent event, such as default by the general partner). Although a limited partnership's organizational documents may give the limited partners the ability to remove the general partner, that stated right may not always have substance. ASC 810-10-25-14A defines substantive kick-out rights that are specific to limited partnerships as follows:

For limited partnerships, the determination of whether kick-out rights are substantive shall be based on a consideration of all relevant facts and circumstances. For kick-out rights to be considered substantive, the limited partners holding the kick-out rights must have the ability to exercise those rights if they choose to do so; that is, there are no significant barriers to the exercise of the rights. Barriers include, but are not limited to, the following:

- Kick-out rights subject to conditions that make it unlikely they will be exercisable, for example, conditions that narrowly limit the timing of the exercise
- Financial penalties or operational barriers associated with dissolving (liquidiating) the limited partnership or replacing the general partners that would act as a significant disincentive for dissolution (liquidation) or removal
c. The absence of an adequate number of qualified replacement general partners or the lack of adequate compensation to attract a qualified replacement

d. The absence of an explicit, reasonable mechanism in the limited partnership's governing documents or in the applicable laws or regulations, by which the limited partners holding the rights can call for and conduct a vote to exercise those rights

e. The inability of the limited partners holding the rights to obtain the information necessary to exercise them.

Although this guidance is specific to limited partnerships, reporting entities may analogize to it when evaluating kick-out rights related to entities other than limited partnerships.

5.3.1.2.5 Evaluation of Liquidation and Withdrawal Rights as Kick-Out Rights

ASC 810-10-20 provides the following voting interest entity definition of kick-out rights:

The rights underlying the limited partner's or partners' ability to dissolve (liquidate) the limited partnership or otherwise remove the general partners without cause.

As discussed in Section 7.2.10.3, paragraph BC49 of ASU 2015-02 notes the FASB's view that liquidation rights "should be considered equivalent to kick-out rights [because they] provide the holders of such rights with the ability to dissolve the entity and, thus, effectively remove the decision maker's authority." Accordingly, any liquidation right should be considered a kick-out right as long as the right (1) is substantive\(^6\) and (2) gives a simple majority (or lower threshold)\(^7\) of limited partners with equity investment at risk the ability to liquidate a limited partnership without cause. As described in Sections 7.2.10 and D.1.6, if the substantive kick-out right is held by a single limited partner, it may result in that limited partner's consolidation of the limited partnership (under both the VIE and voting interest entity models).

Liquidation rights must be distinguished from withdrawal rights since ASC 810-10-25-14B indicates that a limited partner's unilateral right to withdraw from an entity that does not require dissolution or liquidation of the entire entity "would not be deemed a kick-out right." Therefore, a reporting entity should carefully analyze withdrawal rights to determine whether, on the basis of the specific facts and circumstances, they represent liquidation rights. In a manner similar to liquidation rights, when the exercise of a withdrawal right does require the dissolution or liquidation of the entire limited partnership, the right should be considered a kick-out right only if it (1) is substantive, (2) gives a simple majority (or lower threshold) of limited partners the ability to withdraw without cause, and (3) results in the liquidation of the limited partnership.\(^8\)

Note also that special consideration is necessary when a liquidation right (or a withdrawal right that represents a liquidation right) is exercisable in the future as opposed to currently exercisable. Generally, the right would be ignored until exercisable unless there are no significant decisions to be made before the right becomes exercisable. See Section 7.2.9.1 for a more detailed discussion of future potential voting rights.

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\(^6\) Paragraph BC49 of ASU 2015-02 states that "[b]arriers to exercise may be different when considering kick-out rights as compared with barriers for liquidation rights and should be evaluated appropriately when assessing whether the rights are substantive."

\(^7\) Excluding liquidation rights held by the general partner, entities under common control with the general partner, or other parties acting on behalf of the general partner as described in Section 5.3.1.2.3.

\(^8\) As stated in ASC 810-10-25-14B, "[r]equirement to dissolve or liquidate the entire limited partnership upon the withdrawal of a limited partner or partners shall not be required to be contractual for a withdrawal right to be considered as a potential kick-out right." Therefore, a reporting entity must consider whether withdrawal will practically result in the required dissolution of the partnership (e.g., the partnership has only one limited partner and the general partner has a nominal interest). All facts and circumstances must be considered in determining whether the withdrawal requires dissolution or liquidation.
5.3.1.2.6 Evaluation of Buy-Sell Clauses as a Liquidation Right

A buy-sell term in a contractual agreement can take various forms. However, in an arrangement in which two investors each own 50 percent of an entity, a buy-sell clause generally gives the investors the ability to offer to buy out the entire equity interest of another investor (the “offeree”) upon giving notice to the offeree. The investor making the offer (the “offeror”) typically names a price for the offeree’s interest at its discretion. After receiving the offer from the offeror, the offeree typically is contractually required to either (1) sell its entire interest in the entity to the offeror at the named price or (2) buy the offeror’s interest at the named price. Buy-sell agreements are not typically considered liquidation rights.

Example 5-31

Investor A (the managing member) and Investor B (the nonmanaging member) each own 50 percent of LLC, a limited liability company. As the managing member, A makes all of the most significant decisions regarding LLC. Both investors have the right to initiate a buy-sell clause that, once initiated, will result in ownership by one of the investors in 100 percent of LLC and may result in the liquidation of LLC. We do not believe that this scenario is akin to a liquidation right that would be deemed a kick-out right. Although B can initiate the buy-sell, it can only offer to buy A’s interest. However, A has the first right to buy B’s interest instead. Said differently, a buy-sell clause does not operate like a unilateral liquidation right, because A has the option to retain control over LLC’s assets.

5.3.1.2.7 Substantive Participating Rights

A limited partnership would also not be considered a VIE if the limited partners with equity at risk have substantive participating rights (provided the other criteria to not qualify as a VIE are met). Note that the definition of participating rights in the evaluation of whether a limited partnership is a VIE is the same definition as that applied in the voting interest entity model (see Section D.2 for a detailed discussion of the determination of whether noncontrolling rights are substantive participating rights or protective). Accordingly, the analysis focuses on whether the limited partners can participate in the significant financial and operating decisions of the limited partnership (i.e., the voting interest entity definition that focuses on decisions made in the ordinary course of business, such as selecting and terminating management and setting its compensation or making operating and capital decisions) rather than in the most significant activities of the entity (i.e., the VIE model definition).

ASC 810-10-25-13 provides guidance on evaluating whether participating rights are substantive. Factors that must be considered include the percentage ownership interest of the parties with the participating rights, the relationship between the parties with the rights and others involved with the partnership, and the activities in which the parties can participate.

5.3.1.2.8 Reassessing Whether Kick-Out or Participating Rights Exist

In the evaluation of kick-out or participating rights, it is sometimes necessary to reconsider those rights. A scenario may exist in which, upon formation, a limited partnership is a VIE because the general partner, along with entities under common control or parties acting on its behalf, has sufficient interests to prevent a simple majority of the limited partners from exercising kick-out rights. After the limited partnership’s formation, its governing documents are amended to permit a simple majority of the limited partners, excluding the general partner (and entities under common control or parties acting on its behalf), to exercise the kick-out rights that accrue to those interest holders irrespective of the holdings of the general partner.

ASC 810-10-35-4(e) indicates when the initial determination of VIE status should be reconsidered, noting that such reconsideration should take place if “[c]hanges in facts and circumstances occur such that the holders of the equity investment at risk, as a group, lose the power from voting rights or similar rights of
those investments to direct the activities of the entity that most significantly impact the entity’s economic performance."

In the scenario above, the holders of the equity investment at risk effectively gain power as a result of the general partner’s disposal of its kick-out rights as opposed to losing the power to direct activities (as would be the case if the general partner obtained additional kick-out rights). However, the right to exercise power over the significant activities of an entity is fundamental to the determination of whether an entity is a VIE and, if so, whether the holder of a variable interest in the VIE is the primary beneficiary. Accordingly, either a gain or a loss of power to direct the activities of a limited partnership that most significantly affect its economic performance should be deemed a reconsideration event in the context of evaluating whether a substantive kick-out or participating right exists. Accordingly, if such a reconsideration event occurs, the partners would need to reconsider all the requirements of ASC 810-10-15-14 in determining whether the limited partnership is a VIE.

5.3.1.2.9 Partnerships in the Extractive and Construction Industries

As stated in ASC 810-10-15-14(b)(1)(ii), partnerships in the extractive and construction industries that are accounted for under the pro rata method of consolidation would not be considered VIEs solely because the limited partners do not have substantive simple majority kick-out or participating rights.

5.3.2 The Obligation to Absorb the Expected Losses of the Legal Entity

A legal entity shall be subject to consolidation under the guidance in the Variable Interest Entities Subsections if, by design, any of the following conditions exist. (The phrase by design refers to legal entities that meet the conditions in this paragraph because of the way they are structured. For example, a legal entity under the control of its equity investors that originally was not a VIE does not become one because of operating losses. The design of the legal entity is important in the application of these provisions.) . . .

b. As a group the holders of the equity investment at risk lack any one of the following three characteristics: . . .

2. The obligation to absorb the expected losses of the legal entity. The investor or investors do not have that obligation if they are directly or indirectly protected from the expected losses or are guaranteed a return by the legal entity itself or by other parties involved with the legal entity. See paragraphs 810-10-25-55 through 25-56 and Example 1 (see paragraph 810-10-55-42) for a discussion of expected losses. . . .

If interests other than the equity investment at risk provide the holders of that investment with these characteristics or if interests other than the equity investment at risk prevent the equity holders from having these characteristics, the entity is a VIE. . . .

A legal entity is a VIE if the holders of equity investment at risk do not have the obligation to absorb the expected losses. Equity interests are expected to be the most residual interests in a legal entity. If the equity interests do not absorb the expected losses of the legal entity, the party protecting the equity interests from losses may be the party that has a controlling financial interest. Further, such structuring suggests that the legal entity is different from a typical legal entity and that, therefore, application of the voting interest entity model may not yield meaningful results.

The relevance of the guidance in ASC 810-10-15-14(b)(2) was clearer when it was part of FIN 46(R), and consolidation of a VIE depended primarily upon which party was exposed to a majority of the expected losses. The linkage is now less apparent between the root cause of a determination that a legal entity is a VIE (e.g., a guarantor protecting equity investors from certain expected losses) and the party that ultimately consolidates (see Chapter 7). Nonetheless, the FASB retained this guidance, presumably
because it still believes that any legal entity that has variable interests that protect the equity investors from expected losses requires additional scrutiny as a VIE.

Determining whether the equity investors lack the obligation to absorb expected losses requires the application of judgment. Logically, equity investors do not have the obligation to absorb the expected losses of a legal entity if another interest protects them from absorbing those losses, either in part or in full. Equity investments typically absorb first-dollar loss in a legal entity; to the extent that an agreement or instrument protects the equity investors from absorbing that first-dollar loss, the condition in ASC 810-10-15-14(b)(2) is met (and the legal entity would be a VIE). A quantitative analysis of expected losses is generally not required. In the performance of a qualitative analysis, judgment should be applied that takes into account the totality of the legal entity’s capital structure and the associated rights.

To qualitatively assess whether the equity at risk has the obligation to absorb a legal entity’s expected losses, a reporting entity should consider the contractual arrangements that it and other interest holders have with each other and with the potential VIE that may protect one or more holders of equity investment at risk from the expected losses or guarantee them a return (e.g., a guarantee of the residual value of the majority of the fair value of the potential VIE’s assets, or a contractual arrangement that guarantees a 5 percent return).

In addition, a reporting entity should consider the contractual allocation of cash flows in determining whether the equity investment at risk absorbs the first risk of loss of a potential VIE to the extent of its equity invested. If a qualitative analysis indicates that no interests (1) are subordinate to the equity investment at risk, (2) protect the equity investors at risk, or (3) guarantee the equity investors a return, the analysis is generally sufficient for the assessment of whether the equity investment at risk has the obligation to absorb the expected losses of the legal entity.

A variety of agreements and instruments protect the equity investors and therefore can be indicative of a VIE. The following are potential examples of these agreements and interests:

- Total return swaps (financial instruments that transfer an investor’s exposure to a legal entity, in full, for a return in something else).
- Guaranteed returns (terms in an agreement that promise an investor in the legal entity a certain return on its investment in a legal entity).
- Certain supply arrangements (contracts under which a purchaser acquires output and pays for the cost of a legal entity’s production).
- Residual value guarantees (agreements under which a lessee pledges to a lessor that a subject asset will have a certain value after the passage of a certain amount of time).
- Certain guarantees of the legal entity’s indebtedness, to the extent that the financial instrument would prevent losses from being absorbed by the equity investors.
- Certain puts with a fixed exercise price, to the extent that the financial instrument transfers the first-dollar risk of loss to a counterparty.
- Agreements with certain counterparties to reimburse the losses of an equity investor.

In each of the above examples, exposure to first-dollar loss is transferred away from the group of equity investors. Interests that a legal entity acquires in the ordinary course of its business — like certain insurance policies, certain indemnification agreements, and equivalent agreements — do not share that design and accordingly would not result in the identification of a legal entity as a VIE. Likewise, arrangements among equity holders to share losses in a proportion other than that suggested by relative equity ownership does not result in the identification of a legal entity as a VIE.
There is no direct linkage between a conclusion about the sufficiency of equity investment at risk (as discussed in Section 5.2) and a conclusion about the obligation to absorb expected losses among the equity investors at risk as a group. Although the variable interest holders of a legal entity may determine that the total equity investment at risk exceeds expected losses, the analysis focuses on whether the holders of the equity investment at risk are actually the sole group exposed to those expected losses before other parties involved with the legal entity. If the holders of the equity investment at risk are protected (e.g., because another party has provided a limited guarantee on assets that comprise more than half the total fair value of the legal entity's assets) or are guaranteed a return, the legal entity is a VIE. Note that the guidance in Section 4.3.11 on interests in specified assets must be considered. If the protection from losses relates to an interest in a specified asset (rather than in the legal entity as a whole), it would not cause the legal entity to be a VIE under this criterion.

Example 5-32

Assume that Enterprises A and B form a joint venture (Entity C) that does not qualify for any of the scope exceptions to the VIE model. The joint venture consists mostly of three assets (all real estate assets), each with a fair value representing 33 percent of C's total assets. The real estate assets have been guaranteed by different third parties, each unrelated to A and B. Each guarantor is required to absorb decreases in the value of the real estate asset specific to the guarantor's respective guarantee up to a stipulated amount. The guarantor's loss absorption occurs before any absorption by the equity holders.

In this example, the guarantees do not prevent the equity holders (A and B), as a group, from absorbing the expected losses of the legal entity, because each of the guarantors is considered to hold a variable interest in a specific asset under ASC 810-10-25-55 and 25-56 rather than a variable interest in the legal entity as a whole. ASC 810-10-25-56 states, in part, “Expected losses related to variable interests in specified assets are not considered part of the expected losses of the legal entity for purposes of . . . identifying the primary beneficiary unless the specified assets constitute a majority of the assets of the legal entity” (emphasis added). Therefore, since the guarantees are not considered variable interests in C (the legal entity), C is not a VIE under this condition.

Note that the third-party guarantors need to consider the “silo” guidance discussed in Chapter 6.

Example 5-33

Assume the same facts as in Example 5-32 except that the guarantor guaranteed two or three of the real estate assets. The guarantor must aggregate its interests in determining whether it has a variable interest in the legal entity. The variable interest in specific assets represents a majority of the fair value of the entity's total assets; therefore, the expected losses of the assets, excluding the guarantee, would be considered part of the expected losses of the legal entity. Because the equity holders as a group would be protected from such expected losses by the guarantee variable interest, they would lack the obligation to absorb the expected losses of the legal entity.

Note that if this example were changed so that the equity holders absorbed the first risk of loss up to the amount of their equity investments before the performance under the guarantee, the equity interests would not lack the obligation to absorb the expected losses of the legal entity in accordance with ASC 810-10-15-14(b)(2).

Example 5-34

Assume the same facts as in Example 5-32 except that the guarantors of the real estate assets are related parties. As in Example 5-33, the guarantees must be aggregated, which represents a majority of the fair value of the legal entity's total assets; thus, the guarantors would hold variable interests in the legal entity (rather than specified assets), and the equity interests lack the obligation to absorb the expected losses of the legal entity.
Example 5-35
Assume the same facts as in Example 5-32 except that one of the joint venture’s real estate assets constitutes the majority of the fair value of C’s total assets. As in Examples 5-33 and 5-34, the guarantee is related to a majority of C’s total assets; thus, the guarantor would hold a variable interest in the legal entity (rather than specified assets), and the equity interests lack the obligation to absorb C’s expected losses.

5.3.2.1 Put Option on an Equity Interest
The right of equity holders (individually or as a group) in a legal entity to put their equity interest to another party not otherwise involved with the legal entity at a fixed price would not prevent the equity investors at risk from having the obligation to absorb the expected losses of the legal entity. Although the fixed-price put (whether physically or cash settled) protects the individual equity holder(s) from the expected losses of the legal entity, the put is with a party not otherwise involved with the legal entity. That is, the holder or holders of equity investment at risk purchase the put from an unrelated third party outside the legal entity. Therefore, the put option does not cause the legal entity to be a VIE under ASC 810-10-15-14(b)(2) because the counterparty to the put, if exercised, will become a holder of equity investment at risk and will be exposed to the expected losses and residual returns of the entity.

Note that a put option on an equity investment to the legal entity or another party involved with the legal entity would disqualify the equity from being at risk. See Section 5.2.2.4.1 for further information.

5.3.2.2 Put Option on Assets
The right of a legal entity to put, at a fixed price, a majority of its assets (based on fair values) to another party implies that the holders of equity investment at risk, as a group, lack the obligation to absorb the expected losses of the legal entity. The holders of the equity investment at risk lack the obligation to absorb the expected losses of the legal entity because the purchased put protects the equity holders from the expected losses related to the decrease in value of the assets.

Conversely, the counterparty to a put option on less than a majority of a legal entity’s assets (based on fair values) would hold an interest in specified assets as opposed to a variable interest in the legal entity (as long as the counterparty does not have another variable interest in the entity — see Section 4.3.11). Therefore, the equity investment at risk would continue to have the obligation to absorb the expected losses of the legal entity.

5.3.2.3 Other Variable Interests Held by Equity Investors
The existence of other variable interests between the equity investors or other parties and the legal entity that absorb expected losses may cause the legal entity to be a VIE. If the terms of the arrangement cause the first dollar of expected losses to be absorbed by another interest before the equity investment at risk, the arrangement protects the holders of equity at risk from some portion of the expected losses. This same conclusion applies whether the legal entity enters into an arrangement with the equity investor or with another related or unrelated party.
Example 5-36

Investors B and C each have a 45 percent equity interest in a joint venture, all of which qualifies as equity at risk. Investor D has a 10 percent equity interest in the joint venture that does not qualify as equity at risk. Profits and losses are allocated between the investors according to their ownership interests after payments are made to all other interests in the joint venture.

In this scenario, while D's equity interest is not considered equity at risk, it still absorbs expected losses and receives residual returns at the same level as the equity at risk. That is, D is not protecting the other equity investors from absorbing the first-dollar risk of loss. Therefore, the equity at risk does not lack the obligation to absorb the expected losses of the legal entity.

Example 5-37

Investors B and C each have a 50 percent equity interest in a joint venture (JV), all of which qualifies as equity at risk. Investor C has also entered into a contract to supply raw materials to JV at prices below those that could be obtained through sales with unrelated third parties (supply contract). The supply contract is considered a variable interest because the equity holders are protected from the losses associated with that contract. That is, the supply contract is reallocating expected losses associated with the below-market pricing from the equity interests directly to C.

In examining how the supply contract absorbs losses before the equity investment at risk, assume that there are no other variable interest holders. The expected losses of JV are $110 and are allocated as follows:

- Below-market supply contract — Investor C = $10.
- 50 percent equity — Investor B = $50.
- 50 percent equity — Investor C = $50.

In this scenario, the design of JV is such that the supply contract absorbs $10 of expected losses before the equity investment at risk. Although C is an equity holder, the supply contract is not part of the equity investment at risk. Therefore, the equity at risk lacks the obligation to absorb the expected losses of JV.

Example 5-38

An investor owns 100 percent of the equity issued by a legal entity, all of which is considered equity at risk. An unrelated enterprise enters into a contract to purchase finished product from the legal entity at a price equal to the actual costs of production (including costs of raw materials, labor, etc.) plus a 2 percent fixed margin. The purchase agreement is designed so that the purchaser absorbs all variability associated with the production of the finished product. There are no other variable interest holders in the entity.

In this example, because the purchaser absorbs all of the variability related to the manufacturing of the products under the purchase agreement, the investor is protected from some portion of expected losses. Therefore, the equity at risk lacks the obligation to absorb the expected losses of the legal entity.
5.3.3 The Right to Receive the Expected Residual Returns of the Legal Entity

A legal entity shall be subject to consolidation under the guidance in the Variable Interest Entities Subsections if, by design, any of the following conditions exist. (The phrase by design refers to legal entities that meet the conditions in this paragraph because of the way they are structured. For example, a legal entity under the control of its equity investors that originally was not a VIE does not become one because of operating losses. The design of the legal entity is important in the application of these provisions.) . . .

b. As a group the holders of the equity investment at risk lack any one of the following three characteristics: . . .

3. The right to receive the expected residual returns of the legal entity. The investors do not have that right if their return is capped by the legal entity’s governing documents or arrangements with other variable interest holders or the legal entity. For this purpose, the return to equity investors is not considered to be capped by the existence of outstanding stock options, convertible debt, or similar interests because if the options in those instruments are exercised, the holders will become additional equity investors.

If interests other than the equity investment at risk provide the holders of that investment with these characteristics or if interests other than the equity investment at risk prevent the equity holders from having these characteristics, the entity is a VIE. . . .

A legal entity is a VIE if the holders of equity investment at risk are “capped” on receipt of the expected residual returns. This is because the owners of equity investment at risk would typically not give away the right to those residual profits and, consequently, the rights allocated to the equity investment at risk in such an entity should be discounted (i.e., application of the voting interest entity model may not yield meaningful results). Rights to residual returns can accrue to parties other than the holders of equity investment at risk in a number of ways, including (but not limited to):

- Explicitly stated contractual terms in organizing documents.
- Agreements between the owners of equity investment at risk and other counterparties.
- Agreements between the legal entity and the owners of equity investment at risk.

The threshold in ASC 810-10-15-14(b)(3) is unlike that established for the obligation to absorb expected losses described in Section 5.3.2, under which the legal entity is a VIE if the equity holders are protected from any expected losses. Under ASC 810-10-15-14(b)(3), the legal entity is a VIE only if the residual returns are capped, a distinction that allows for residual returns to be shared with parties that do not hold equity investment at risk. A cap is an upward limit, a ceiling above which all residual returns are received by a variable interest holder that does not represent equity investment at risk. In practice, because of this distinction, it is rare for a legal entity to qualify as a VIE under this guidance, whereas a legal entity is frequently a VIE because its equity investors at risk are protected from expected losses.

Note that stock options, convertible debt, or similar interests do not cap residual returns because if the options in those instruments are exercised, the holders will become additional equity investors. Similarly, a return to an at-risk equity investor is generally not capped by an outstanding fixed-price call option on the investor’s equity because the holder of the option would become an equity investor if the option were exercised (see Section 5.3.3.2 for an exception to this rule). The distinction in these instruments is the alignment of return and equity ownership. However, it is not correct that only holders of equity investment at risk can share in the residual returns of a legal entity (e.g., profit sharing is permissible as long as it does not cap the return to the equity holders). Likewise, it is not necessary for an equity investment at risk to have the same rights to residual returns as another equity investment; disproportionate profit sharing is permissible as long as it does not result in an impact to the group of holders of equity investment at risk in a manner akin to a cap. Reporting entities should apply judgment in considering the effects of financial instruments and profit-sharing arrangements.
For a legal entity to qualify as a voting interest entity, the rights to its expected residual returns must not be capped. A reporting entity must use significant judgment and evaluate all relevant facts and circumstances to determine whether returns are capped. Investors should not be considered to have the right to receive the expected residual returns of the legal entity if their participation in the return of a legal entity is trivial beyond a specified amount.

The following are examples of situations in which residual returns generally would be considered capped:

- The investment manager receives a performance-based fee equal to all investment returns above 15 percent in any annual period.
- The legal entity is designed to serve as a profit-sharing vehicle for employees of a sponsoring reporting entity at which all returns on assets of more than 6 percent are allocated to the employees.

The following are examples of situations in which holders of the equity investment at risk generally would not be considered capped:

- The investment manager receives a performance-based fee equal to 10 percent of all investment returns up to 15 percent and thereafter shares in investment returns 30/70 with the equity investors.
- The legal entity is designed to serve as a profit-sharing vehicle for employees of a sponsoring reporting entity at which 50 percent of the returns on assets of more than 6 percent are allocated to the employees.

**Example 5-39**

Investors B and C each have a 45 percent equity interest in a joint venture, all of which qualifies as equity at risk. Investor D has a 10 percent equity interest in the joint venture that does not qualify as equity at risk. Profits and losses are allocated according to ownership interests after payments are made to all other interests in the joint venture. Investor D is also entitled to an additional 5 percent of profits (not losses) above a specified threshold.

In this scenario, while D is entitled to additional profits above a specified threshold, D's equity interest shares losses and residual returns at the same level as the equity interest (pari passu) of B and C. Although D's interest has a beneficial feature that the equity investors at risk (B and C) do not have, B's and C's returns are not capped. Therefore, the equity at risk does not lack the characteristic in ASC 810-10-15-14(b)(3).

**5.3.3.1 Determining the Effect of a Call Option on an Entity’s Assets on the Ability of the Equity Group to Receive Residual Returns**

A fixed-price call option written by the legal entity on specified assets of the legal entity that represent more than 50 percent of the total fair value of a legal entity's assets would be considered a cap on the holders of equity investment at risk right to receive the expected residual returns of the legal entity. However, if the aggregate amount of call options with a counterparty and its related parties is on assets constituting 50 percent or less of the total fair value of a legal entity's assets, it would not represent a cap on the residual returns of the holders of equity investment at risk.
Example 5-40

Entity A leases equipment to several unrelated lessees under operating leases. The lessees hold fixed-price purchase options on the leased equipment that are exercisable at the expiration of the lease terms. The initial fair value of equipment under one of the leases is more than 50 percent of the fair value of A’s total assets. Therefore, that lessee's purchase option under that lease would be a variable interest in the legal entity. Because the purchase option would cap the holder of the equity investment at risk's right to receive residual returns pursuant to ASC 810-10-15-14(b)(3) (i.e., the equity investors at risk of A do not participate in the appreciation in value of the related equipment), A would be a VIE.

5.3.3.2 Determining the Effect of a Call Option on an Entity’s Equity on the Ability of the Equity Group to Receive Residual Returns

As discussed in Section 5.3.3, a return to an at-risk equity investor is generally not capped by an outstanding fixed-price call option on the investor’s equity because the holder of the option would become an equity investor if the option were exercised. However, in determining whether a legal entity is a VIE, a reporting entity should consider the substance of the call option on equity as well as the design of the legal entity. In instances in which the fixed-price call option on the equity is economically identical to a call on the specified assets held by the legal entity, it would be appropriate to conclude that the residual returns to the equity group are capped and that, therefore, the legal entity is a VIE. This would be the case when the call option is held on 100 percent of the equity and the VIE was designed to hold specified assets. In that circumstance, there is no substantive difference between an option to acquire the specified assets (as described in Section 5.3.3.1) and a call on 100 percent of the legal entity’s equity.

5.4 Nonsubstantive Voting Rights

ASC 810-10

15-14 A legal entity shall be subject to consolidation under the guidance in the Variable Interest Entities Subsections if, by design, any of the following conditions exist. (The phrase by design refers to legal entities that meet the conditions in this paragraph because of the way they are structured. For example, a legal entity under the control of its equity investors that originally was not a VIE does not become one because of operating losses. The design of the legal entity is important in the application of these provisions.) . . .

c. The equity investors as a group also are considered to lack the characteristic in (b)(1) if both of the following conditions are present:

1. The voting rights of some investors are not proportional to their obligations to absorb the expected losses of the legal entity, their rights to receive the expected residual returns of the legal entity, or both.

2. Substantially all of the legal entity’s activities (for example, providing financing or buying assets) either involve or are conducted on behalf of an investor that has disproportionately few voting rights. This provision is necessary to prevent a primary beneficiary from avoiding consolidation of a VIE by organizing the legal entity with nonsubstantive voting interests. Activities that involve or are conducted on behalf of the related parties of an investor with disproportionately few voting rights shall be treated as if they involve or are conducted on behalf of that investor. The term related parties in this paragraph refers to all parties identified in paragraph 810-10-25-43, except for de facto agents under paragraph 810-10-25-43(d).

For purposes of applying this requirement, reporting entities shall consider each party’s obligations to absorb expected losses and rights to receive expected residual returns related to all of that party’s interests in the legal entity and not only to its equity investment at risk.
Although intended to clarify ASC 810-10-15-14(b)(1) (see Section 5.3.1), ASC 810-10-15-14(c) is generally considered a separate condition in the assessment of a VIE. ASC 810-10-15-14(c)(2) explains that the provision “is necessary to prevent a primary beneficiary from avoiding consolidation of a VIE by organizing the legal entity with nonsubstantive voting interests.” Thus, ASC 810-10-15-14(c) is often referred to as the “anti-abuse provision” since it aims to prevent legal entities from being structured in a manner in which a party does not have voting control but in substance should be consolidated by a reporting entity that meets the “substantially all” criteria. Such legal entities would be evaluated under the VIE model.

Although intended to address abuse, ASC 810-10-15-14(c) also applies to reporting entities other than those that circumvent the VIE rules. Many legal entities established with valid business purposes may qualify as VIEs under this guidance. Furthermore, a reporting entity that has been determined to have met the “substantially all” criterion does not automatically consolidate the VIE.

When considering this guidance, a reporting entity must perform the following steps:

- **Step 1** — Determine whether one investor has disproportionately few voting rights relative to that investor’s economic exposure to a legal entity.
- **Step 2** — Assess whether substantially all of the activities of a legal entity either involve or are conducted on behalf of the investor identified in step 1, including that investor’s related parties and some de facto agents.

If a legal entity satisfies all the criteria in both steps 1 and 2, its voting rights are considered nonsubstantive and it is therefore a VIE. A reporting entity would then evaluate the legal entity for consolidation under the VIE model.

### 5.4.1 Disproportionately Few Voting Rights (Step 1)

ASC 810-10-15-14(c) reflects the FASB’s belief that having disproportionately few voting rights creates a potential for abuse, since an investor would be unlikely to accept economic exposure in excess of its voting rights. In the assessment of what constitutes “disproportionately few,” the voting rights an investor holds and the exposure to economics retained by an investor are each expressed as a percentage of the respective total. If the percentage of relative voting rights is smaller than the percentage of relative economic exposure, the criterion is met.

Legal entities are often structured with multiple classes of stock, and those classes may carry voting rights that are conditional or that carry different weight. Limited partnerships and limited liability corporations often identify one party — the general partner or managing member — as the decision maker, endowed with all power related to decisions in the ordinary course of business, irrespective of the equity owned by that party. In other circumstances, the exact percentage of total voting rights that an investor holds may not be of specific importance. For example, in a situation in which two investors hold 60 percent and 40 percent of the voting rights, respectively, and a 66.6 percent threshold is required for a decision, each party should be considered to have 50 percent of the voting rights of the legal entity regardless of the actual voting rights held.

Judgment will also be required in the determination of an investor’s economic exposure. Economic exposure in this context incorporates the definition of a variable interest (see Section 2.14 and Chapter 4) by reference to the obligation to absorb expected losses or the right to receive expected residual returns. It is clear, therefore, that the anti-abuse provision is not intended to encompass only the exposure to economics conveyed by the same interests that convey the right to vote. Investors will often have exposure to economics through variable interests in addition to equity interests in a legal entity. Examples include debt financing, decision-maker fees, and guarantees. Finally, an investor’s economic
exposure should include implicit variable interests and “activities around the entity,” as described in Section 4.3.10.1.

Though these assessments will require the use of judgment, we generally believe that the threshold for satisfying this criterion will be low. Given the purpose of the guidance, it will often be obvious when voting rights and economic exposure are disproportionate. An investor with a majority of economic exposure and less than a majority of voting rights clearly has disproportionately few voting rights.

If an investor has disproportionately few voting rights, step 2 should be performed (see Section 5.4.2).

The anti-abuse provision focuses on all investors in the legal entity, not only a specific reporting entity. Consequently, if a reporting entity has disproportionately many voting rights, another investor will by default have disproportionately few voting rights, and the condition will be met. A conclusion that the reporting entity alone does not have disproportionately few voting rights is insufficient. Note that under step 1, related parties and de facto agents are ignored (although implicit variable interests and activities around the legal entity through a related party may be relevant, and thus an understanding of the totality of a reporting entity’s variable interests is required). Instead, the focus is on variable interests held specifically by an investor.

### 5.4.1.1 Impact of Variable Interests in Addition to Equity

When determining whether a reporting entity’s voting rights are proportional to its obligations to absorb the expected losses of the legal entity or to its rights to receive the expected residual returns of the legal entity, a reporting entity must consider all of its variable interests issued by the legal entity, including those held by reporting entities that do not also hold equity investment at risk.

The FASB staff has indicated that the anti-abuse provision requires a reporting entity to consider each possible scenario in determining whether its voting rights are proportionate to its obligations to absorb the expected losses or rights to receive the expected residual returns of the legal entity. Therefore, a reporting entity that holds a voting equity investment at risk and any other variable interest not proportionately held by other equity interest holders (e.g., debt, service contract that is a variable interest, guarantee) will always meet ASC 810-10-15-14(c)(1).

### Example 5-41

Enterprises X and Y each contribute $1 million (aggregate equity of $2 million) in exchange for a 50 percent equity interest in an entity. This entitles each enterprise to equal voting rights. Enterprise Y, but not X, also provides subordinated debt. ASC 810-10-15-14(c)(1) is met because Y’s total variable interests, as a percentage of the total of all variable interests of holders of equity investment at risk, are greater than its voting rights (50 percent). This is true even if Y’s specific amount of expected losses and expected residual returns is less than the $2 million equity investment at risk. In other words, although subordinated debt is not expected to absorb any of the expected losses, Y could experience losses or returns that are disproportionate to its 50 percent voting interest.
Example 5-42

Company J and Company E each contribute $500,000 (aggregate equity of $1 million) in exchange for a 50 percent equity interest in a chemical manufacturing entity. This entitles each company to equal voting rights in the entity. Company J, but not E, also receives fees for managing the chemical manufacturing entity. The fees paid to E meet the conditions to be “commensurate” under ASC 810-10-55-37(a) and “at market” under ASC 810-10-55-37(d); however, as a result of E’s equity interests in the chemical manufacturing entity that absorb more than an insignificant amount of the potential VIE’s variability, the condition in ASC 810-10-55-37(c) is not met and the fees therefore represent a variable interest. In this case, ASC 810-10-15-14(c)(1) is met because E’s total variable interests, as a percentage of the total of all variable interests of holders of equity investment at risk, are greater than its voting rights (50 percent). Although the fees paid to E are not expected to absorb any of the expected losses, E could experience returns that are disproportionate to its 50 percent voting interest.

Example 5-43

Company B and Company D are equity investors in Conglomerate T and hold 90 percent and 10 percent voting interests, respectively. Company B has a majority of the voting rights in T (through its 90 percent voting interest) and has a majority of the exposure to T’s profits and losses (through its 60 percent participation). In this case, ASC 810-10-15-14(c)(1) is not met even though B’s voting rights (90 percent) and exposure to T’s economics (60 percent) are not equal. Company B has control of T; therefore, B’s voting rights and economic interests are proportional at either the 90 percent or 60 percent threshold.

5.4.2 Substantially All of the Activities Involve or Are Conducted on Behalf of the Investor With Disproportionately Few Voting Rights (Step 2)

A legal entity that has an investor with disproportionately few voting rights is not a VIE unless substantially all of its activities either involve or are conducted on behalf of that investor (including that investor’s related parties and all but one type of its de facto agents\(^9\)). This provision is intended to prevent a reporting entity from circumventing the requirements for consolidating a VIE by forming the VIE primarily for its own use with voting rights that do not equate to the allocation of the underlying economic gains and losses of holders of interests in the formed VIE.

Many components of this provision will already be known: the investor with disproportionately few voting rights will have been identified in step 1; that investor’s related parties and de facto agents will be identified; and the legal entity’s activities can be determined on the basis of its purpose and design. However, a reporting entity will need to exercise significant judgment in determining whether the “substantially all” requirement has been met.

Speaking at the 2003 AICPA Conference on Current SEC Developments, an SEC staff member, Eric Schuppenhauer, discussed this provision:

The second part of this provision is where more judgment is involved. In the event that a registrant concludes that it has disproportionately few voting rights compared to its economics, there must be an assessment of whether substantially all of the activities of the entity either involve or are conducted on behalf of the registrant. There is no “bright-line” set of criteria for making this assessment. All facts and circumstances, qualitative and quantitative, should be considered in performing the assessment.

Under ASC 810-10-15-14(c)(2), the term “activities” refers to the business activities of the potential VIE under evaluation. It does not necessarily encompass the economic interests (i.e., the obligation of the interest holders to absorb expected losses or the right of the interest holders to receive expected residual returns). A reporting entity must also understand the business reason why an investor chooses to accept voting rights that are not proportionate to its investment.

\(^9\) This condition specifically excludes de facto agents resulting from a unilateral transfer restriction under ASC 810-10-25-43(d). See Section 8.2 for discussion of de facto agents.
“Substantially all” is a high threshold. Generally, if 90 percent or more of the legal entity’s activities either involve or are conducted on behalf of a reporting entity and its related parties, they are presumed to be “substantially all” of the legal entity’s activities. However, less than 90 percent is not a safe harbor. The evaluation should not necessarily be based on the reporting entity’s economic interest(s) in a legal entity. However, significant economic interests in a legal entity may be an indicator that substantially all of the legal entity’s activities either involve or are conducted on behalf of the reporting entity and its related parties.

A reporting entity will generally need to perform a qualitative analysis to determine whether substantially all of the activities of a legal entity either involve or are conducted on behalf of an investor, its related parties, and some de facto agents. This “substantially all” terminology is used in a manner parallel to its use in the business scope exception discussed in Section 3.4.4.7 and should be applied in a consistent manner. The following factors, among others, may be useful in the evaluation of whether substantially all of a legal entity’s activities either involve or are conducted on behalf of a reporting entity:

- **Business relationship of the legal entity and the reporting entity** — Does the reporting entity contractually acquire substantially all of the output of the legal entity? Does the legal entity have the substantive ability to provide its output to other entities, or is the legal entity solely tied to the reporting entity?

- **Type of business conducted by the legal entity** — Does the legal entity serve a function beyond providing inputs to the reporting entity (i.e., is the legal entity just an extension of the reporting entity)? Does the legal entity rely on inputs provided exclusively by the reporting entity to conduct its operations?

- **Economic dependence of the legal entity upon the reporting entity** — Does the reporting entity absorb substantially all of the losses of the legal entity? Does the reporting entity have the responsibility to fund losses of the legal entity?

- **Operational dependence of the legal entity on the reporting entity** — Does the reporting entity provide the employees that operate the legal entity’s business?

- **Origins of the legal entity** — Did the reporting entity form the legal entity to perform a specific function that the reporting entity had historically performed on its own?

- **Ongoing linkage of the entities** — Do the reporting entity and legal entity have the ability to put or call the assets of the legal entity in the future under favorable terms?

No single factor is necessarily determinative. The facts and circumstances associated with a legal entity should be considered in total in the assessment of whether ASC 810-10-15-14(c)(2) has been met.

### Example 5-44

Two investors, Enterprise A and Enterprise B, form a joint venture (JV) solely to manufacture steel. Enterprises A and B contribute cash of $80 million and $20 million, respectively, to fund JV, and each investor has 50 percent of the voting rights. In addition, 90 percent of JV’s manufactured steel is sold to A, and 10 percent is sold to third parties.

In this scenario, JV satisfies ASC 810-10-15-14(c)(1) because A's share in losses of JV is disproportionate to its voting rights (80 percent share of losses compared with 50 percent voting rights). JV also satisfies ASC 810-10-15-14(c)(2) because substantially all of JV’s activities (90 percent of the output) are conducted on behalf of A, the investor with disproportionately few voting rights. Therefore, since the equity investors as a group lack the characteristic in ASC 810-10-15-14(b)(1) (i.e., both conditions in ASC 810-10-15-14(c) have been met), JV is a VIE.

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\[10\] See footnote 9.
Example 5-44 (continued)

Conversely, if JV were to sell 50 percent or more of its manufactured steel to unrelated third parties, JV would not be a VIE. If sales to A are greater than 50 percent but less than 90 percent, judgment should be used in the determination of whether JV meets both criteria in ASC 810-10-15-14(c) when no other activity besides sales is relevant to the evaluation.

Example 5-45

An investment hedge fund (Entity Z) is established by a 99 percent limited partner (Enterprise A) and a 1 percent general partner (Enterprise B). Enterprise B manages the hedge fund and makes all decisions. Enterprise A cannot remove B except for cause. Therefore, the voting rights are not proportional to the share of expected losses and expected residual returns of Z. Substantially all of Z’s activities would be considered to be on behalf of A because Z is established to invest its money and provide a return to A. Therefore, because Z meets both conditions of ASC 810-10-15-14(c), it would be deemed a VIE.

Conversely, if limited partner interests were held by a larger number of unrelated limited partners, Z would not be considered a VIE under ASC 810-10-15-14(c). Note, however, that Z would be deemed a VIE under ASC 810-10-15-14(b) in both scenarios because the limited partner and partners do not have substantive rights to kick out the general partner.

Example 5-46

Entity X is formed by Enterprise A and Enterprise B with equity contributions of $80 million and $20 million, respectively. Each investor has a 50 percent voting interest. Entity X’s activities consist solely of purchasing merchandise from A and selling and distributing it to third-party customers.

Entity X satisfies ASC 810-10-15-14(c)(1) because the voting rights of the investors are not proportional to their obligation to absorb X’s expected losses. Therefore, X’s investors must consider ASC 810-10-15-14(c)(2).

While the “outputs” of X are not transactions with A or B, the business of X represents another distribution or sales channel for A’s merchandise. Entity X appears to be an extension of A’s business because it is so closely aligned in appearance and purpose. Entity X has been designed so that substantially all of its activities either involve or are conducted on behalf of A (the investor that has disproportionately few voting rights). Therefore, ASC 810-10-15-14(c)(2) is met, and X is a VIE.

Example 5-47

Enterprise A and Enterprise B form Entity Y with equity contributions of $80 million and $20 million, respectively. Each investor has a 50 percent voting interest. Entity Y has contracted to purchase all of its raw materials from A. Entity Y is one of several customers of A. Entity Y uses these raw materials to manufacture products to sell to third-party customers identified by Y.

Entity Y meets ASC 810-10-15-14(c)(1) because the voting rights of the investors are not proportional to their obligation to absorb the expected losses of the legal entity. Therefore, the investors of Y must consider ASC 810-10-15-14(c)(2).

Entity Y sells its products directly to third parties. That is, the “outputs” of Y are not transactions conducted directly with A or B. Even though all of the raw materials of Y are provided by A, Y does not appear to be an extension of A’s business and would not be considered to be designed so that substantially all of its activities either involve or are conducted on behalf of the investor that has disproportionately few voting rights. (This is different from the situation in Example 5-46 above.) Therefore, ASC 810-10-15-14(c)(2) is not met, and Y is not a VIE.
Chapter 6 — Silo Provisions

6.1 Introduction

ASC 810-10

25-57 A reporting entity with a variable interest in specified assets of a VIE shall treat a portion of the VIE as a separate VIE if the specified assets (and related credit enhancements, if any) are essentially the only source of payment for specified liabilities or specified other interests. (The portions of a VIE referred to in this paragraph are sometimes called silos.) That requirement does not apply unless the legal entity has been determined to be a VIE. If one reporting entity is required to consolidate a discrete portion of a VIE, other variable interest holders shall not consider that portion to be part of the larger VIE.

25-58 A specified asset (or group of assets) of a VIE and a related liability secured only by the specified asset or group shall not be treated as a separate VIE (as discussed in the preceding paragraph) if other parties have rights or obligations related to the specified asset or to residual cash flows from the specified asset. A separate VIE is deemed to exist for accounting purposes only if essentially all of the assets, liabilities, and equity of the deemed VIE are separate from the overall VIE and specifically identifiable. In other words, essentially none of the returns of the assets of the deemed VIE can be used by the remaining VIE, and essentially none of the liabilities of the deemed VIE are payable from the assets of the remaining VIE.

It is important for a reporting entity to determine whether, in performing the VIE analysis under ASC 810-10, its variable interest is in a legal entity itself or in a silo of the legal entity (sometimes referred to as a VIE within a VIE). We have not provided a flowchart at the beginning of this chapter to indicate where the identification of silos fits in the consolidation analysis, nor does the FASB specifically mention silos in its flowchart in ASC 810. The identification of silos is, in short, a unit-of-account question. If silos exist (and the host is a VIE), the variable interest holders would effectively treat them as separate structures that could be consolidated separately from the broader legal entity. Throughout this chapter, the term “host” refers to the remaining legal entity after the removal of all of the identified silos. In other words, if a silo (or multiple silos) exists and the host is a VIE, the units of account for potential consolidation would be each respective silo and the host itself. The assessment of whether a silo exists should generally be made at the time of initial involvement with a potential VIE and upon the occurrence of reconsideration events described in Chapter 9.

The silo concept appears only in the VIE subsections of ASC 810-10. The FASB established this concept in response to concerns that reporting entities could avoid consolidation by combining separate pools of assets or activities into a single legal entity while effectively segregating the right to govern the activities, the right to receive the benefits, and the obligation to absorb the losses of each separate pool of assets or activities, effectively creating a VIE within a VIE. Such scenarios will generally only result from either (1) specific regulatory constructs or (2) deliberate legal structuring (see Section 6.2.3). Accordingly, silos typically exist in very limited circumstances. If a silo exists within a VIE, a reporting entity with a variable interest in the silo should determine whether consolidating it separately from the legal entity as a whole is appropriate.
The following flowchart outlines the reporting entity's analysis of whether a silo should be considered for consolidation.

### 6.2 Evaluation of Silos

A silo will typically exist, and should be considered for consolidation separately from the legal entity as a whole, when the following characteristics are present:

- Essentially all of the assets, liabilities, and equity (if any) related to the subset of activities or assets are separate from the remainder of the legal entity.
- Essentially none of the liabilities or claims associated with the subset of assets (activities) being evaluated are payable from the assets of the host entity.
- The host entity is a VIE.

#### 6.2.1 The “Essentially All/Essentially None” Threshold

A silo will typically exist when the obligations or claims of the holder of a variable interest in specified assets are not commingled with the obligations or claims of the holders of other variable interests in specified assets or other interests in the legal entity as a whole. To this effect, ASC 810-10-25-58 indicates that a portion of the legal entity should be treated as a silo if essentially all of the assets, liabilities, and equity (if applicable) related to the subset of activities or assets being evaluated are separate from the legal entity and are specifically identifiable. That is, a portion of the legal entity should be treated as a silo if essentially none of the returns of the subset of assets or activities being evaluated can be used by the host entity and essentially none of the liabilities or claims associated with the subset of assets or activities being evaluated are payable from the assets of the host entity. “Essentially all” is
not specifically defined; however, we have generally interpreted it to mean that 95 percent or more of the assets, liabilities, and equity of the potential silo are separate from the legal entity and that the related expected losses and expected residual returns inure to the interest holders in the potential silo.

The purpose of the “essentially all/essentially none” threshold is to limit silo identification to instances in which both:

- The holder of a liability or other interest in the specified assets or activities does not have the ability to look to the legal entity as a whole for compensation if it has a loss in value or cash flows, and the holder’s risk and return exposure is limited to the specifically identified asset or group of assets.
- The legal entity as a whole does not have a significant legal claim on the specified assets or group of assets and is not dependent on the returns of the specified assets to satisfy other claims on the legal entity as a whole. That is, the second condition that must be met for a potential silo to be present is that the assets are segregated from the general claims of the legal entity as a whole and the legal entity as a whole essentially does not participate in changes in fair value or cash flows associated with those assets.

The second characteristic distinguishes interests in specified assets that should be viewed as silos from other interests in specified assets that would be analyzed under ASC 810-10-25-55 and 25-56 (see Section 4.3.11) as part of the host entity.

**Example 6-1**

Assume that a lessor entity is formed and capitalized with $4 of equity and two $98 loans that have recourse to the entity (the loans are cross-collateralized) and uses the proceeds to purchase two $100 buildings. The entity leases each of the buildings to unrelated lessees. Each lease includes a fixed-price purchase option and provides a residual value guarantee to the lessor entity. Assume also that the entity as a whole is a VIE because it lacks sufficient equity investment at risk.

The fixed-price purchase option and the residual value guarantee embedded in each lease represent variable interests in specified assets because they provide the lessee with the ability to participate only in the economic performance of the specified building that is subject to the lease agreement. However, no silos exist because each building is not essentially the only source of payment for the entity’s debt. The expected losses and residual returns of each of the buildings do not inure to a specified liability (the debt, being cross collateralized, absorbs expected losses of the whole entity) or to specified other interests.

**Example 6-2**

Assume that a lessor entity is formed and capitalized with $4 of equity from two unrelated investors. The entity obtains third-party financing in the form of two $98 nonrecourse loans (Loans A and B) and uses the proceeds of Loan A to purchase Building A for $100 and the proceeds of Loan B to purchase Building B for $100. The rental cash flows from Building A can only be used to repay Loan A, and the rental cash flows from Building B can only be used to repay Loan B. The equity is separate from the overall entity, specifically identifiable, and linked to each building and loan of the entity. The entity leases each of the buildings to unrelated lessees. Each lease includes a fixed-price purchase option and provides a residual value guarantee to the lessor entity.

In this example, the entity as a whole does not have any substantive equity investment at risk, because each class of equity participates only in the profits and losses of the building to which it relates. The equity, loan, fixed-price purchase option, and residual value guarantee for each building absorb essentially all of the variability of the specified building, and essentially none of the variability in the specified building accrues to the entity as a whole. Thus, because the essentially all/essentially none criteria have been met, two separate silos exist. Each silo consists of a building, its related nonrecourse debt, and an allocation of equity.
6.2.2 Determining Whether a Host Entity Is a VIE

For a silo to exist, a reporting entity must determine that the legal entity being evaluated for consolidation is a VIE. However, as discussed in ASC 810-10-25-55 through 25-57, variability that is absorbed by a variable interest in specified assets or by a silo (explained in more detail below) is generally excluded from the legal entity before the assessment of whether the host entity itself is a VIE. Because a silo is reflective of variable interests in specified assets, the variability associated with the silo must be excluded from the legal entity before an assessment of whether the legal entity is a VIE can be performed. However, a silo cannot exist if the legal entity is not a VIE.

In determining whether a silo exists, a reporting entity should, as part of its evaluation of the sufficiency of the equity investment at risk and of the primary beneficiary associated with the host entity, exclude the variability associated with the silo if the first two conditions noted in Section 6.2 have been met. Similarly, the reporting entity can deduct the fair value of the silo’s assets, regardless of whether the silo has a primary beneficiary. In evaluating whether the host entity is a VIE, the reporting entity must exclude the variability associated with specified assets absorbed by the holder of the variable interest in the specified assets (see Section C.3.6 for further discussion of this calculation).

**Example 6-3**

Entity A’s balance sheet is as follows (on a fair value basis):

<table>
<thead>
<tr>
<th>Assets</th>
<th>Liabilities and Equity</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash</td>
<td>$ 25</td>
</tr>
<tr>
<td>Other assets</td>
<td>$ 85</td>
</tr>
<tr>
<td>Building</td>
<td>$ 160</td>
</tr>
<tr>
<td><strong>Total assets</strong></td>
<td><strong>$ 270</strong></td>
</tr>
<tr>
<td>Accounts payable</td>
<td>$ 15</td>
</tr>
<tr>
<td>Debt*</td>
<td>$ 155</td>
</tr>
<tr>
<td>Equity</td>
<td>$ 100</td>
</tr>
<tr>
<td><strong>Total liabilities and equity</strong></td>
<td><strong>$ 270</strong></td>
</tr>
</tbody>
</table>

* This debt has recourse only to the building.

Reporting Entity B leases a commercial real estate asset that is approximately 59 percent of the fair value of Entity A’s assets. The remaining assets are cash and other assets. The lease contains a first-loss residual value guarantee of the building and a fixed-price purchase option to acquire the property for the option price at the end of the lease term. The lease is considered an interest in specified assets under ASC 810-10-25-55. Reporting Entity B (the lessee) does not have any other interests in A. The debt of $155 has full recourse to the building in the event of default.

The building and debt are considered a silo because (1) B is required to provide a first-loss residual value guarantee if the fair value of the leased building is below the option price; (2) the debt, which is only recourse to the building, represents essentially all (greater than 95 percent) of the building’s financing ($155 of debt ÷ $160 of building = 97%); and (3) all of the residual returns associated with the building inure to the lessee because of the fixed-price purchase option in the lease.

After the amounts associated with the silo (building and debt) are removed, the assets are $110 and the liabilities are $15. On the basis of a qualitative assessment, it is determined that A’s equity at risk is sufficient. As long as A met the two other conditions in ASC 810-10-15-14, A would not be a VIE. Therefore, since A (exclusive of the silo) is not a VIE, B does not need to consider whether it should consolidate the silo.

Some have asserted that the requirement to exclude variability absorbed by variable interests in specified assets, or silos, from the legal entity before the evaluation of whether the host entity is a VIE, effectively permits the conclusion that the legal entity as a whole is not a VIE and obviates the need for an assessment of whether identified silos must be consolidated on their own. This is because if a silo exists, once it is excluded from the legal entity as a whole, the host entity that remains after the potential silo is excluded is often a shell company with little or no activities of its own. Because a shell company,
by definition, needs little or no equity investment at risk to conduct its activities, and few, if any, decisions must be made to direct the activities that will significantly affect its economic performance, some have asserted that the characteristics in ASC 810-10-15-14(a) and (b) are not present, and accordingly, that the legal entity as a whole will not be a VIE.

We have generally disagreed with this assertion because it would effectively render the silo guidance irrelevant. The purpose of that guidance is to identify situations in which segregated portfolios of activities have been aggregated into a single legal entity with the potential goal of avoiding consolidation by the reporting entity that would otherwise be the primary beneficiary of an individual segregated portfolio. Furthermore, if more than one portfolio of activities is conducted in a single legal entity, but the power to direct those activities and the risks and rewards associated with the activities have been isolated from one another, the variable interests in specified assets, in the aggregate, may absorb essentially all of the economic performance of the legal entity as a whole while no individual variable interest participates significantly in the profits and losses, or has the power to direct the activities, of the legal entity as a whole. Such a scenario would be strong evidence that the characteristics in ASC 810-10-15-14(a) or (b) are present and, accordingly, that the legal entity as a whole is a VIE. If a contrary conclusion were reached, the legal entity as a whole would be a voting interest entity. Since the silo concept does not exist for voting interest entities and, therefore, the silos would never be considered for consolidation, we do not believe this would be an appropriate outcome.

SIFMA and AMIAPG formally discussed this concept with the SEC staff in the context of international series funds in which each series represents a silo. After those discussions, SIFMA and AMIAPG sent a letter in January 2016 to the SEC staff to confirm the staff’s views on determining whether the host entity is a VIE. The letter also generally confirmed our view above and states, in part:

If the individual series funds do not meet the definition of a legal entity for consolidation purposes, then the umbrella should be assessed to determine whether it is a voting interest entity or a variable interest entity (VIE). In performing this assessment, the guidance on interests in specified assets and silos in ASC 810-10-25-55 through 25-58 should be applied.

Accordingly, if the umbrella has no assets, liabilities or equity other than that which relates to individual series (e.g., the fair value of the specified assets of each of the individual series within the umbrella is not more than half of the total fair value of the umbrella’s assets) the SEC Staff would not object to a view that the umbrella is a VIE. Under this view, the variable interests in specified assets (i.e., the equity of each series) would generally not represent equity investment at risk of the umbrella for purposes of applying the guidance in ASC 810-10-15-14. Consequently, the umbrella would meet the condition of ASC 810-10-15-14b since interests other than equity investment at risk (i.e., equity of each series) provide the holders of that investment with power, and, accordingly, the umbrella would be considered a VIE.

If the umbrella is a VIE, then each silo (i.e., individual series fund) would be evaluated for consolidation as a separate VIE in accordance with ASC 810-10-25-57.

The letter continued to state, in part:

The SEC Staff noted that preparers with views that differ from those outlined above (e.g., preparers that intend to continue to apply an alternative view regarding the assessment of equity-at-risk at the umbrella that results in a conclusion that the umbrella has equity consistent with a voting interest entity) are encouraged to formally consult with the SEC Staff to review their specific facts and circumstances.

Although the SEC staff did not formally object to an alternative view that the host entity could be considered a voting interest entity in these circumstances, on the basis of comments made by the SEC staff, we do not believe that a public company should take this position without formal consultation with the staff. This guidance applies to private companies as well.

Because a silo cannot be a VIE unless the host entity is a VIE, if it is determined that the host entity is not a VIE, the silo would no longer be viewed as a separate entity, and the entire entity would be evaluated for consolidation under other consolidation guidance. We believe that if the host entity is a VIE, the silo
will generally be a VIE as well and that a primary-beneficiary analysis should therefore be performed for both the silo and host entity (see Section 6.3). To the extent that a reporting entity believes that a silo is not a VIE, the reporting entity should also consider consulting with its advisers.

6.2.3 Silos in the Insurance and Asset Management Industries

Given the nature of the essentially all/essentially none characteristics described in Section 6.2.1, the existence of silos tends to be fairly limited outside of the insurance and asset management industries. In the insurance industry, the regulatory and legal constructs are designed and commonly used to reduce the regulatory and financial burden on industry participants by allowing for the creation of a single legal entity while legally segregating separate and distinct pools of activities or assets from one another. In such instances, the activities of each pool are conducted on behalf of variable interest holders in the individual pools. Specifically, it is common for reinsurers to use “segregated cell structures” (commonly referred to as “rent a cell” or “rent a captive”) to allow investors and reinsurers to participate in specific pools of insurance risk without needing to establish a new insurance company for each pool. Instead, the larger legal entity that houses all of the pools is the only legal entity that must establish itself as an insurer.

Similarly, in the asset management industry it is common to use a “series trust” structure to allow for the creation of new investment fund “series” within the larger series trust to provide shared use of the series trust infrastructure while also letting holders of shares issued by each series participate only in the economic performance of the series that has issued their shares. See Section 3.2.1 for further discussion of series trusts.

It is also our experience that in segregated cell companies, the legal or regulatory construct that allows for the effective segregation of the various pools of activities also causes the legal entity as a whole to be a VIE. This is because although the legal entity as a whole typically issues a nominal amount of common shares, substantially all of the equity interests of the cell company are issued by individual cells, and such equity interests participate only in the returns and losses of the issuing cell. Thus in the evaluation of the legal entity as a whole to ascertain whether it is a VIE, the legal entity as a whole is typically lacking any substantive equity investment at risk since if a legal entity is composed almost entirely of various cells, no individual group of equity meets the requirement in ASC 810-10-15-14(a)(1) that equity investments participate significantly in the legal entity’s profits and losses (see Section 5.2.2.1). Similarly, because essentially none of the returns of the cell accrue to the legal entity as a whole, the legal entity as a whole typically does not have any substantive activities once the activities of the cells have been stripped out.

6.3 Determining the Primary Beneficiary of the Host Entity and Silo

Once it is determined that both the host entity and the silo(s) are VIEs, the reporting entity must evaluate each of them separately to determine which party, if any, is the primary beneficiary of the host entity and which party, if any, is the primary beneficiary of the silo. In analyzing which party, if any, is the primary beneficiary of the host entity, the reporting entity should exclude the silo’s expected losses and residual returns (and thus the activities that give rise to these expected losses and residual returns) to determine which party has both (1) the power to direct the activities that most significantly affect the economic performance of the host entity and (2) the obligation to absorb losses and the right to receive benefits that could potentially be significant to the host entity (see Chapter 7 for identifying the primary beneficiary). That is, only the host entity’s activities, benefits, and losses should be used in the analysis. If a related-party relationship exists such that the related-party tiebreaker test would be performed (see Section 7.4.2.4), the factors in that paragraph should be applied only to the host entity.
Likewise, in analyzing which party is the primary beneficiary of the silo, the reporting entity should exclude the host entity's expected losses and residual returns (and thus the activities that give rise to these expected losses and residual returns) in identifying which party has both (1) the power to direct the activities that most significantly affect the economic performance of the silo and (2) the obligation to absorb losses and the right to receive benefits that could potentially be significant to the silo.

A reporting entity that has a variable interest in a host entity should also consider the guidance in ASC 810-10-25-57, which states, “If one reporting entity is required to consolidate a discrete portion of a VIE, other variable interest holders shall not consider that portion to be part of the larger VIE.” This guidance precludes two parties from consolidating the same assets, liabilities, and equity of a silo. Further, even if no party is identified as the primary beneficiary of a silo when the host is a VIE, it would generally not be appropriate for the silo to be added back to the host entity (i.e., the assets, liabilities, and equity of the silo would not be consolidated by the primary beneficiary, if any, of the host entity).
Chapter 7 — Determining the Primary Beneficiary

Evaluate under VIE model.

Does the reporting entity have power and potentially significant economic exposure (through its direct and indirect interests)? (Sections 7.2 and 7.3)

Yes

Reporting entity consolidates the VIE.

No

Is power shared and does the related-party group have potentially significant economic exposure? (Section 7.4.2.2)

Yes

Perform related-party tiebreaker test (Section 7.4.2.4). The party most closely associated with the VIE consolidates the VIE.

No

Is there a single decision maker?

Yes

That single variable interest holder in the related-party group consolidates the entity.

No

No

Stop consolidation analysis.*

Is there a single decision maker?

Yes

Stop consolidation analysis.*

No

Does the related-party group have power and potentially significant economic exposure and are substantially all of the activities of the VIE conducted on behalf of a single variable interest holder?** (Section 7.4.2.5)

Yes

No

That single variable interest holder in the related-party group consolidates the entity.

Stop consolidation analysis.*

* Consolidation is not required; however, other GAAP may be relevant to the determination of recognition, measurement, or disclosure.

** Interests in low-income housing tax partnerships within the scope of ASU 2014-01 would not be subject to this requirement.
7.1 Introduction

ASC 810-10

25-38 A reporting entity shall consolidate a VIE when that reporting entity has a variable interest (or combination of variable interests) that provides the reporting entity with a controlling financial interest on the basis of the provisions in paragraphs 810-10-25-38A through 25-38J. The reporting entity that consolidates a VIE is called the primary beneficiary of that VIE.

25-38A A reporting entity with a variable interest in a VIE shall assess whether the reporting entity has a controlling financial interest in the VIE and, thus, is the VIE's primary beneficiary. This shall include an assessment of the characteristics of the reporting entity's variable interest(s) and other involvements (including involvement of related parties and de facto agents), if any, in the VIE, as well as the involvement of other variable interest holders. Paragraph 810-10-25-43 provides guidance on related parties and de facto agents. Additionally, the assessment shall consider the VIE's purpose and design, including the risks that the VIE was designed to create and pass through to its variable interest holders. A reporting entity shall be deemed to have a controlling financial interest in a VIE if it has both of the following characteristics:

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. The quantitative approach described in the definitions of the terms expected losses, expected residual returns, and expected variability is not required and shall not be the sole determinant as to whether a reporting entity has these obligations or rights.

Only one reporting entity, if any, is expected to be identified as the primary beneficiary of a VIE. Although more than one reporting entity could have the characteristic in (b) of this paragraph, only one reporting entity if any, will have the power to direct the activities of a VIE that most significantly impact the VIE's economic performance.

The primary beneficiary of a VIE is the party required to consolidate the VIE (i.e., the party with a controlling financial interest in the VIE). The analysis for identifying the primary beneficiary is consistent for all VIEs. Specifically, ASC 810-10-25-38A requires the reporting entity to perform a qualitative assessment that focuses on whether the reporting entity has both of the following characteristics of a controlling financial interest in a VIE:

- **Power** — The power to direct the activities that most significantly affect the VIE's economic performance (see Section 7.2).
- **Economics** — The obligation to absorb losses or the right to receive benefits of the VIE that could potentially be significant to the VIE (see Section 7.3).

Throughout this Roadmap, we refer to these characteristics individually as the “power criterion” and the “economics criterion.” This chapter discusses the two characteristics as well as the related-party implications associated with the primary-beneficiary analysis. In addition, Appendix E contains implementation guidance from ASC 810-10-55, which provides sample cases illustrating evaluations of the primary beneficiary.

7.1.1 Requirement to Perform the VIE Primary-Beneficiary Assessment

A reporting entity must evaluate whether it is the primary beneficiary of a VIE if (1) the legal entity (or reporting entity) does not qualify for a consolidation scope exception or a scope exception related to application of the VIE model (see Chapter 3), (2) it has a variable interest in a legal entity (see Chapter 4), and (3) the legal entity is a VIE (see Chapter 5).
A reporting entity that does not have a variable interest in a VIE (e.g., the entity’s only involvement in
the VIE is limited to a fee arrangement that has been determined not to be a variable interest) would
never be the VIE’s primary beneficiary. ASC 810-10-25-38A states, in part, “A reporting entity with a
variable interest in a VIE shall assess whether the reporting entity has a controlling financial interest
in the VIE and, thus, is the VIE’s primary beneficiary” (emphasis added). In addition, paragraph A42 in the
Background Information and Basis for Conclusions of FASB Statement 167 states, in part:

[If an enterprise concludes that its involvement in a variable interest entity does not represent a variable
interest, further analysis of whether the enterprise's obligation to absorb losses or its right to receive benefits
could potentially be significant would not be required because a party cannot be the primary beneficiary of an
entity if that party does not hold a variable interest in the entity.

Further, the decision tree in ASC 810-10-05-6 instructs the reporting entity to stop the consolidation
analysis and consider other relevant GAAP if the reporting entity does not have a variable interest in the
VIE. See Chapter 4 for further discussion of identifying variable interests.

In addition, if a legal entity is not a VIE, a reporting entity is not required to evaluate whether it is the
primary beneficiary of the legal entity under the VIE model. Instead, the reporting entity may need
to evaluate whether it should consolidate the legal entity under the voting interest entity model (see
Appendix D). Although the consolidation analysis under the VIE and voting interest entity models
both focus on whether a reporting entity has a controlling financial interest over the legal entity being
evaluated, the evaluations are not identical. See Table 1-1 in Section 1.4 for differences between the
voting interest entity model and the VIE model.

7.1.2 Multiple Primary Beneficiaries

It is inappropriate for more than one reporting entity to consolidate the same VIE. However, each
reporting entity holding an interest in a legal entity independently determines (often on the basis of
significant judgment) whether the entity is a VIE and, if so, the VIE’s primary beneficiary. Therefore, if the
reporting entities do not reach a consistent conclusion, it is possible for more than one reporting entity
to conclude that it should consolidate the same legal entity.

Note that despite this principle, a reporting entity may not conclude that it should not consolidate a VIE
solely because another reporting entity has concluded that it should consolidate the VIE. Each reporting
entity must independently analyze its involvement with a legal entity, including whether the entity is a VIE
and whether it should consolidate the VIE.

7.1.3 No Primary Beneficiary

The VIE primary-beneficiary assessment is not intended to result in more than one primary beneficiary
for a VIE, nor does it require that every VIE have a primary beneficiary. There may be situations in
which a reporting entity determines that neither it nor any of the other interest holders are the VIE’s
primary beneficiary. This could occur under ASC 810-10-25-38D if, for example, power is “shared among
multiple unrelated parties such that no one party has the power to direct the activities of a VIE that
most significantly impact the VIE’s economic performance.” See Section 7.2.7.1 for further discussion of
shared power.
7.1.4 Application of the VIE Model When an Entity Is Not the Primary Beneficiary

A reporting entity that has a variable interest in a VIE but does not appear to be the VIE's primary beneficiary must still apply the VIE requirements because the reporting entity must still disclose certain information about the VIE in accordance with ASC 810-10-50-4. See Sections 11.2.2 and 11.2.4 for further discussion of disclosure requirements for VIEs when a reporting entity is not the primary beneficiary. Thus, even when it appears that an investor would not be the primary beneficiary of a legal entity, the legal entity is still within the scope of the VIE model unless it is determined that:

- The legal entity or reporting entity qualifies for a scope exception in ASC 810-10-15-12 or ASC 810-10-15-17 (see Chapter 3).
- The legal entity is not a VIE (see Chapter 5).

7.1.5 Initial Assessment and Reconsideration of the Primary Beneficiary of a VIE

The initial assessment of whether a reporting entity is the primary beneficiary of a VIE should be performed on the date the reporting entity first becomes involved with a VIE. The reporting entity must then continually reassess whether it is the primary beneficiary of the VIE throughout the entire period the reporting entity is involved with the VIE (i.e., not only at the end of each reporting period; the requirement to perform a continual reassessment is consistent with that for voting interest entities — see Appendix D). A reporting entity may become involved with a VIE as of the date of its design or another date (e.g., when the reporting entity initially became involved with a non-VIE that later became a VIE because of a reconsideration event; see Chapter 9).

Although a continual assessment of the primary beneficiary is required, because consolidation of a VIE is based on the power to direct activities of the VIE, it is unlikely that the primary-beneficiary conclusion will change periodically in the absence of specific transactions or events that have an impact on the controlling financial interest in a VIE. Paragraph A19 in the Basis for Conclusions of Statement 167 states:

“On the basis of the amendments to the guidance in [ASC 810-10-25-38] for determining the primary beneficiary of a variable interest entity, the Board expected that the ongoing assessment of which [reporting entity], if any, is the primary beneficiary would require less effort and be less costly than the quantitative assessment of expected losses and residual returns previously required by [the VIE model in ASC 810-10]. Furthermore, the Board expected that the amendments to [ASC 810-10-25-38] would reduce the frequency in which the [reporting entity] with the controlling financial interest changes.

A change in the determination of whether a reporting entity has both of the characteristics of a controlling financial interest could occur as a result of any of the following events or circumstances:

- There is a change in the design of a VIE (e.g., a change in the governance structure or management of the VIE, a change in the activities or purpose of a VIE, or a change in the primary risks that the VIE was designed to create and pass through to variable interest holders).
- A VIE issues additional variable interests, retires existing variable interests, or modifies the terms of existing variable interests (e.g., a VIE modifies the terms of existing variable interests, and the modification affects the power of the variable interest holder to influence the activities of the VIE).
- There is a change in the counterparties to the variable interests of a VIE (e.g., a reporting entity acquires or disposes of variable interests in a VIE, and the acquired [disposed-of] interest, in conjunction with the reporting entity's other involvement with the VIE, causes the reporting entity to gain [lose] the power to direct the activities that most significantly affect the VIE's economic performance).
A significant change in the anticipated economic performance of a VIE (e.g., as a result of losses significantly in excess of those originally expected for the VIE) or other events (including the commencement of new activities by a VIE) result in a change in the reporting entity that has the power to direct the activities that most significantly affect the VIE’s economic performance.

Two or more variable interest holders become related parties under common control or are no longer considered related parties under common control, and such a related-party group has (had) both the power to direct the activities of the VIE and the obligation (right) to absorb losses (benefits) that could potentially be significant to the VIE, but neither related party individually possesses (possessed) both characteristics.

A contingent event occurs that transfers the power to direct the activities of the entity that most significantly affect a VIE’s economic performance from one reporting entity to another reporting entity (see Section 7.2.9.2 for a discussion of contingencies in the power analysis).

A troubled debt restructuring.

Note that a reporting entity's analysis of whether the primary beneficiary of a VIE has changed should not be limited to the list of factors above. A reporting entity should consider all facts and circumstances when determining whether the primary beneficiary has changed. Paragraph A14 in the Basis for Conclusions of Statement 167 notes that the FASB believed that indicators (such as the ones listed above) could be important in the analysis of whether there has been a change in the primary beneficiary, but the Board did not want any such factors to limit a reporting entity's analysis of whether the primary beneficiary has changed.

### 7.2 Power Criterion

<table>
<thead>
<tr>
<th><strong>ASC 810-10</strong></th>
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<tr>
<td><strong>25-38B</strong> A reporting entity must identify which activities most significantly impact the VIE’s economic performance and determine whether it has the power to direct those activities. A reporting entity's ability to direct the activities of an entity when circumstances arise or events happen constitutes power if that ability relates to the activities that most significantly impact the economic performance of the VIE. A reporting entity does not have to exercise its power in order to have power to direct the activities of a VIE.</td>
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<tr>
<td><strong>25-38F</strong> Although a reporting entity may be significantly involved with the design of a VIE, that involvement does not, in isolation, establish that reporting entity as the entity with the power to direct the activities that most significantly impact the economic performance of the VIE. However, that involvement may indicate that the reporting entity had the opportunity and the incentive to establish arrangements that result in the reporting entity being the variable interest holder with that power. For example, if a sponsor has an explicit or implicit financial responsibility to ensure that the VIE operates as designed, the sponsor may have established arrangements that result in the sponsor being the entity with the power to direct the activities that most significantly impact the economic performance of the VIE.</td>
</tr>
<tr>
<td><strong>25-38G</strong> Consideration shall be given to situations in which a reporting entity's economic interest in a VIE, including its obligation to absorb losses or its right to receive benefits, is disproportionately greater than its stated power to direct the activities of a VIE that most significantly impact the VIE’s economic performance. Although this factor is not intended to be determinative in identifying a primary beneficiary, the level of a reporting entity’s economic interest may be indicative of the amount of power that reporting entity holds.</td>
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7.2.1 General Framework

Although identification of the primary beneficiary requires an evaluation of both characteristics of a controlling financial interest in a VIE, the determination is often based on which variable interest holder satisfies the power criterion since generally more than one variable interest holder meets the economics criterion.

To determine whether it meets the power criterion, the reporting entity must identify the activities that most significantly affect the VIE’s economic performance and then determine which variable interest holder has the power to direct those activities. The reporting entity would take the following steps to identify the party with the power to direct the activities that most significantly affect the VIE’s economic performance:

- **Step 1** — Evaluate the purpose and design of the VIE and the risks the VIE was designed to create and pass along to its variable interest holders. See Section 7.2.2.
- **Step 2** — Identify the activities related to the risks identified in step 1 that most significantly affect the economic performance of the VIE. In certain situations in which multiple unrelated variable interest holders direct different activities, the reporting entity must determine which activity most significantly affects the VIE’s economic performance. The party that has the power to direct such activity will meet the power criterion. When making this determination, the reporting entity should consider the activity that results in the most economic variability for the VIE (e.g., expected losses and expected residual returns, which are discussed in Appendix C). See Section 7.2.3.
- **Step 3** — Identify the party that makes the significant decisions or controls the activity or activities that most significantly affect the VIE’s economic performance. Consider whether any other parties have involvement in those decisions (shared power) or can remove the decision maker (kick-out rights). See Sections 7.2.4 through 7.2.7.

While a VIE often performs a variety of activities, the key to determining whether the power criterion has been satisfied is identifying the activities that are the most significant to the VIE’s economic performance.

7.2.2 Purpose and Design (Step 1)

The first step in identifying the party with the power to direct the activities that most significantly affect the VIE’s economic performance is to evaluate the purpose and design of the VIE, including the risks and associated variability that the VIE was designed to create and pass through to its variable interest holders. The reporting entity should understand how each risk affects the VIE’s economic performance and should identify the activities related to each risk. The assessment should not be limited to the activities that affect the returns to equity holders and should not be performed on the basis of a single point in time. Rather, the power-criterion assessment should be based on the entire life of the legal entity and all of the legal entity’s assets that contribute to its economic performance in the way the legal entity was designed.

The examples in ASC 810-10-55-93 through 55-205 (see Appendix E) illustrate the performance of step 1. For instance, in Case A (a commercial mortgage-backed securitization), the reporting entity determines that the VIE is exposed to the credit risk associated with the possible default by the borrowers. Ultimately, the VIE’s economic performance is most significantly affected by the credit performance of the VIE’s underlying assets; accordingly, the variable interest holder with the power to direct the activities related to managing the VIE’s assets that are delinquent or in default is the primary beneficiary.
When evaluating the purpose and design of the VIE, the reporting entity should consider how the VIE was marketed to investors, the entity's governing documents, and any other relevant agreements between the VIE and the parties involved with the VIE that could affect its purpose and design.

7.2.3 Risks and Activities (Step 2)

Once a reporting entity has identified the risks the VIE was designed to create and pass through to its variable interest holders, the reporting entity can determine the activities that most significantly affect the economic performance of the VIE. ASC 810-10 does not define “economic performance”; however, the assessment should focus on which activities have the most significant impact on the variability that will be absorbed by the variable interests in the VIE. This determination should be the same as for the VIE analysis (see Section 5.3.1).

Some VIEs may have very limited ongoing activities that significantly affect the economic performance of the VIE. For example, in certain securitization structures, the only significant activity is the management of troubled assets. Other entities, such as operating entities, may conduct a wide range of activities. Activities may even include those that have not yet occurred (e.g., the activity will be performed when certain circumstances arise or certain events happen) as long as they significantly affect the economic performance of the VIE.

7.2.3.1 Risks With No Activities

Reporting entities should consider all risks in assessing whether the power criterion has been met. However, the VIE may be exposed to risks that do not have direct activities related to them, as illustrated in Case E and Case F in ASC 810-10-55-147 through 55-171. In those examples, prepayment is one of the risks the VIE was designed to create and pass through, but since there are no variable interest holders that have the power to direct activities related to the risk, it is not considered in the primary-beneficiary analysis.

7.2.3.2 No Ongoing Activities

In limited situations, the ongoing activities performed throughout the life of a VIE (e.g., administrative activities in certain resecuritization entities, such as Re-REMICs) may not be expected to significantly affect the VIE's economic performance even though they are necessary for the VIE's continued existence. In such situations, the primary-beneficiary determination will need to focus on the activities performed and the decisions made at the VIE's inception as part of the VIE's design, because in these situations the initial design had the most significant impact on the economic performance of the VIE. However, it would not be appropriate to determine the primary beneficiary solely on the basis of decisions made at the VIE's inception as part of the VIE's design when there are ongoing activities that will significantly affect the economic performance of the VIE.

ASC 810-10-25-38F states that a reporting entity’s involvement in the design of a VIE “may indicate that the reporting entity had the opportunity and the incentive to establish arrangements that result in the reporting entity being the variable interest holder with . . . the power to direct the activities that most significantly impact [the VIE’s] economic performance.” However, ASC 810-10-25-38F also notes that a reporting entity’s involvement in the design does not, in itself, establish that reporting entity as the party with power. In many situations, several parties will be involved in the design of a VIE, and an analysis of the decisions made as part of the design would not be determinative, nor would it result in the identification of a primary beneficiary.

In addition, ASC 810-10-25-38G highlights the need for reporting entities to consider situations in which a variable interest holder's economic exposure is disproportionately greater than its stated power to make decisions that affect the VIE's economic performance.
Thus, in situations in which (1) the ongoing activities of a VIE are not expected to significantly affect the VIE's economic performance and (2) one reporting entity holds an economic interest that is so significant that the other interest holders, as a group, do not hold more than an insignificant amount of the fair value of the VIE's interests (or those interests do not absorb more than an insignificant amount of the VIE's variability\(^1\)), it would generally be appropriate to conclude that the reporting entity with that significant economic interest made the decisions at the inception of the VIE or that the decisions were essentially made on the reporting entity's behalf. Therefore, in such situations, it would be appropriate to conclude, after all facts and circumstances associated with the VIE have been considered, that the reporting entity has a controlling financial interest in the VIE. Conversely, if multiple parties were involved in the design of the VIE and hold a variable interest that is more than insignificant, no party would consolidate the VIE.

When performing this analysis, a reporting entity should evaluate whether, on the basis of the purpose and design of the entity, it should consider the interests held by its related parties. For example, if a reporting entity and an affiliate under common control together absorb all but an insignificant amount of the variability in the VIE, the reporting entity (or the reporting entity in the related-party group) may have a controlling financial interest in the VIE. On the other hand, a related party's interest in a related-party relationship resulting from a de facto agency (e.g., a transfer restriction as described in Section 8.2.3.4) may not warrant inclusion in this analysis after the purpose and design of the entity and the nature of the related-party relationship have been considered. In evaluating whether one party in a related-party group should be deemed to have both of the characteristics of a controlling financial interest if the ongoing activities of the VIE are not expected to significantly affect the VIE's economic performance, a reporting entity may consider the factors in ASC 810-10-25-44(a)–(d). The purpose of this evaluation is not to determine whether consolidation of the VIE by one of the related parties is required under the "most closely associated" guidance but rather to assess whether these factors may be indicators that the substance of the arrangement should result in the consolidation of the VIE by one of the related parties. See Section 7.4.2.4 for additional information on these factors.

7.2.4 Which Party, if Any, Has the Power (Step 3) — General Considerations

Step 3 in the determination of which party has the power to direct the activities that most significantly affect the VIE’s economic performance is to identify the party that makes the significant decisions or controls the activities that most significantly affect the VIE’s economic performance. Questions to consider in this analysis include, but are not limited to, the following:

- Does any party hold the power unilaterally?
- Alternatively, do other parties also have relevant rights and responsibilities? For example:
  - Is there another party that has to consent to every important decision (shared power)? See Section 7.2.7.1.
  - Is there another party that can force the reporting entity to take certain actions?
  - Is there another party that can replace the reporting entity without cause (kick-out rights) or liquidate the VIE without cause? See Section 7.2.10.
  - Is there another party or other parties that direct the same activities but for a different portion of the VIE’s assets? See Section 7.2.7.2.
- Is the reporting entity's right to exercise power currently available or contingent on the occurrence of some other event(s)? See Section 7.2.9.

\(^1\) Since the focus is placed on variability, a party with a small overall ownership percentage in a VIE could be exposed to a significant amount of the VIE’s variability (e.g., the holder of a residual interest when there is a large amount of senior interests). Similarly, a party with a large overall ownership percentage in a VIE may not be exposed to a significant amount of the VIE’s variability (e.g., if the party holds senior interests in a VIE whose capitalization also includes substantive subordinated and residual interests).
As part of this analysis, it is important for the reporting entity to distinguish between the ability to make significant decisions that are expected to be made in the ordinary course of carrying out the VIE’s current business activities and the ability to make decisions in exceptional circumstances or to veto or prevent certain fundamental changes in the VIE’s design or activities. The latter are generally considered protective rights, as discussed in ASC 810-10-25-38C, which do not give the reporting entity the power to direct the significant activities of the VIE.

At the 2019 AICPA Conference on Current SEC and PCAOB Developments, an SEC staff member, Professional Accounting Fellow Aaron Shaw, gave a speech on assessing the power to direct the most significant activities in conjunction with the purpose and design and risks and activities of a VIE. In his remarks, Mr. Shaw discussed the determination of the primary beneficiary in circumstances in which a VIE had multiple activities that affected the entity’s economic performance. The registrant in the scenario was the lessee of the VIE’s only asset — a single property. The lease term covered substantially all of the property’s economic life. The lease required the registrant to operate and maintain the property during the lease term; this obligation included significant structural maintenance. At the end of the lease term, the VIE had the right to sell the property. The VIE’s primary purpose was to provide investors with a return on their investment derived from the lease payments and the sale of the property at the end of the lease term. The registrant concluded that although it had multiple variable interests in the VIE, it did not have power over the activities that most significantly affected the VIE’s economic performance.

Mr. Shaw noted that in light of the VIE’s purpose and design, “the risks that caused variability included: lease negotiation risk, lessee credit risk, residual value risk, and operation and maintenance risk.” He stressed that each activity does not necessarily have the same relative weight in a consolidation analysis. For example, the lease term represented substantially all of the property’s economic life. Lease negotiation risk, therefore, was not determined to be the most significant risk. In addition, as Mr. Shaw explained, “[a]ctivities related to lessee credit risk were not the VIE’s most significant activities because the registrant’s financial condition and the property’s strategic importance mitigated credit risk.”

The SEC staff observed that the activities related to residual value risk and operation and maintenance risk were the most significant activities because the decisions related to these risks would most significantly affect the VIE’s economic performance. The registrant held the power to direct operation and maintenance decisions during the lease term, which would most significantly affect the VIE’s economic performance. Consequently, the staff objected to the registrant’s conclusion that the registrant did not have power over the activities that most significantly affected the VIE’s economic performance.

### 7.2.5 Decisions Made by a Board and Management (Step 3)

Assessing whether the power criterion has been met can be more complex when decisions are made by different parties and at different governance levels. For example, in some arrangements, a board of directors is established for the VIE; however, one of the investors may serve as the “managing member” or “managing partner” (referred to in this discussion simply as the “manager”) of the VIE. Because certain decisions will be made by the board of directors, and other decisions will be made by the manager, the first step is to determine whether the manager’s fee arrangement is a variable interest in the VIE. If the manager’s fee arrangement is not a variable interest, the manager is only providing management services as an agent on behalf of the equity investors. Consequently, the rights held by the manager would be attributed to the equity investors or the party on behalf of which the manager is required to act. See Section 4.4 for a discussion of evaluating decision-maker fees as variable interests.
If the manager is deemed to have a variable interest, then to determine which party meets the power criterion, a reporting entity must understand which activities are expected to most significantly affect the economic performance of the VIE and the level in the VIE at which those activities are directed. Items to consider include determining the level in the VIE at which the significant operating and capital decisions are made as well as the level at which the operating and capital budgets are set, the level of detail included in the budgets, the process of developing and approving the budget, implications of the budget not getting approved, and other relevant facts.

If the significant operating and capital decisions are made by the board, a manager would not have the power to direct the activities of the VIE that most significantly affect the economic performance because that power would be held by the board, and the manager would effectively be serving as a service provider. Conversely, if a reporting entity concludes that the most significant activities of the VIE are directed at the manager level (and not at the board level), the board would not be considered to have the power to direct the activities that most significantly affect the economic performance of the VIE unless a single equity holder (or a related-party group of equity holders) controls representation on the board (i.e., has more than 50 percent representation on a board requiring a simple majority vote, thereby indirectly controlling the vote of the board), and the board has substantive rights to kick out the manager (see Sections 5.3.1.2.4 and 7.2.10.1).

The following examples illustrate the application of this concept. Assume in these examples that the legal entities being evaluated are VIEs because they have an insufficient amount of equity at risk:

**Example 7-1**

Investors A and B, two unrelated parties, are investors in Entity X, a manufacturing venture that has one facility. Investor A owns 60 percent of X, and B owns 40 percent of X. Both investors obtained their ownership in X by contributing cash in a ratio equal to their ownership percentages. The terms of the venture arrangement require B to purchase up to 10 percent of the product produced by X at cost-plus. The remainder of the product produced by X is sold to third parties at market rates. Investor B is the managing member of the entity. Entity X's articles of incorporation state the following about the governance and management of X:

- Entity X's board of directors comprises 10 individuals — 5 selected by A and 5 selected by B.
- All significant operating and capital decisions regarding the operations of X, such as establishing operating and capital budgets, determining the pricing of the product produced by X, approving long-term customer contracts, and approving long-term supply contracts for raw materials, must be presented to the board and are determined by a simple majority vote.
- The managing member is responsible for ensuring that the day-to-day operations of X are executed in a manner consistent with the operating plan approved by the board and cannot deviate from the operating plan without approval from the board.
- The managing member reports to the board on a monthly basis.
- Investor B is paid a fixed annual fee for serving as managing member.

Profits and losses of X are split according to ownership percentage. The cost-plus purchase arrangement between B and X represents a variable interest because it is designed such that B reimburses X for all of the actual costs incurred to produce the product B purchases. Therefore, B also absorbs variability in X through the cost-plus pricing terms.

Operating risk (including sales volume risk, product price risk, raw materials price risk, and other operating cost risk) and capital decisions are identified as the risks that will have the most significant impact on X's economic performance. On the basis of the facts presented, which indicate that the key decisions and activities related to operating risk are directed at the board level, it would be appropriate to conclude that power over X is shared. That is, A and B together, through the board of directors, have the power to direct the activities of X, and the voting structure of X essentially results in decisions requiring the consent of both A and B. Although B serves as the managing member of X, it does not have the power to direct the activities that most significantly affect X's economic performance, since those decisions are made at the board level.
Example 7-2

Investors K and W, two unrelated parties, are investors in an energy venture, Entity X, an independent power producer with one power plant located in the southwestern United States. Investor K owns 60 percent of X, and W owns 40 percent of X. Both investors obtained their ownership in X by contributing cash in a ratio equal to their ownership percentages. The terms of the venture arrangement require W to purchase up to 20 percent of the power produced by X at cost-plus; however, the remainder of the power produced by X is sold to third parties at market rates.

Entity X’s articles of incorporation state the following about the governance and management of X:

- Entity X’s board of directors comprises 10 individuals — 6 selected by K and 4 selected by W.
- The following actions cannot be taken without a unanimous vote of the board:
  - Removal of the managing member.
  - Appointment of a replacement managing member.
  - Decisions to make calls for capital contributions.
  - Admission of new members.
  - Amendments to X’s articles of incorporation.
  - Capital expenditures in excess of $100 million. Entity X’s average annual capital expenditures are $20 million. It is not expected that X will have capital expenditures in excess of $100 million.
- Investor W is the managing member and makes all significant operating and capital decisions regarding the operations of X, such as establishing operating and capital budgets, determining the pricing of the power produced by X, determining when to operate the power plant, hiring and firing employees, deciding how to manage environmental risk, and negotiating long-term supply contracts for commodities.
- Investor W is paid a fixed annual fee plus 15 percent of the venture’s profits for serving as managing member.
- Investor W reports to the board on an annual basis.

Profits and losses of X, after payment of W’s managing member fee, are split according to ownership percentage.

Investor W’s equity interest represents a variable interest, as does W’s management fee in accordance with ASC 810-10-55-37(c) (because W’s other interests in X absorb more than an insignificant amount of X’s potential variability). In addition, the cost-plus purchase arrangement between W and X represents a variable interest, because the cost-plus arrangement is designed such that W reimburses X for all of the actual costs incurred to produce the power that W purchases. Therefore, W also absorbs variability in X through the cost-plus pricing terms.

Operating risk (including commodity price risk and environmental risk) and capital decisions are identified as the risks that will have the most significant impact on X’s economic performance. On the basis of the facts presented, which indicate that the most significant decisions and activities related to operating risk are directed at the managing member level, W (the managing member) would be considered to have the power to direct the activities that most significantly affect X’s economic performance. On the basis of the facts and circumstances and the design of X, the rights of the board of directors represent protective rights under ASC 810-10-25-38C. The ability to remove the managing member does not affect the power analysis because no single reporting entity has the unilateral ability to remove W.

Note that if removal of W had been allowed by a simple majority vote of the board of directors, and the removal right had been substantive, K may have been the party with the power to direct the activities that most significantly affect the economic performance of X because K could unilaterally remove W through its majority vote on the board.
7.2.6 Decision-Making Activities by an Agent (Step 3)

In some situations, a decision maker may be acting as an agent on behalf of other parties (see Section 4.4 regarding whether a decision-making arrangement is a variable interest). Even if the decision maker is deemed to be acting as an agent (because it does not have a variable interest), the reporting entity should evaluate the substance of the arrangement to determine whether the decision maker is acting on behalf of another variable interest holder that may have power, such as in the circumstances described in ASC 810-10-25-38G. This situation and some related considerations were addressed by an SEC staff member, Professional Accounting Fellow Chris Rogers, at the 2014 AICPA Conference on Current SEC and PCAOB Developments. Mr. Rogers highlighted in prepared remarks that the VIE consolidation analysis does not stop for the other variable interest holders if it is determined that the fee paid to a decision maker is not a variable interest, because another variable interest holder may be the principal with power. He stated:

For purposes of illustration, assume an entity forms an SPE to securitize loans. The design and purpose of the SPE is to finance the entity's loan origination activities. The entity provides the investors in the SPE with a guarantee protecting against all credit losses. The SPE hires a third party to service the loans and to perform default mitigation activities. Assume the servicer cannot be removed without the consent of investors and its fee is not a variable interest. In thinking through this example, the staff believes that in certain cases it may be necessary to continue the consolidation analysis when it is determined that a fee paid to a decision maker is not a variable interest and further consider whether the substance of the arrangement identifies a party other than the decision maker as the party with power.

While this can require a great deal of judgment, additional scrutiny may be necessary if a decision maker is acting as an agent and one variable interest holder is absorbing all or essentially all of the variability of the VIE. In these situations, stated power may not be substantive, and it may be appropriate to attribute the stated power of the decision maker acting as an agent to the variable interest holder absorbing the variability of the VIE. It is helpful to keep in mind that the level of a reporting entity's economic interest in a VIE may be indicative of the amount of power that the reporting entity holds. While the VIE guidance states that this factor is not determinative in identifying the primary beneficiary, the staff does believe that the level of a reporting entity's economics is an important consideration in the analysis and may be telling of whether stated power is substantive. [Footnote omitted]

A reporting entity should carefully consider whether it has identified a principal, especially if a decision maker is acting as an agent on behalf of one variable interest holder that absorbs essentially all of the variability of the VIE.

The above speech was delivered before the issuance of ASU 2015-02. Although the concepts are still relevant, ASU 2015-02 broadened the evaluation of whether a decision maker is acting as an agent by permitting decision-maker fees to be significant as long as (1) they are commensurate and at market (see Sections 4.4 and 4.4.1) and (2) the decision maker does not hold other interests in the VIE that would absorb more than an insignificant amount of the VIE's variability (see Section 4.4.2.1). We do not believe that the guidance in this speech should generally apply when, for example, a decision maker receives fees that significantly participate in the economic performance of the VIE or the decision-maker fee is a variable interest (see Section 4.4). However, facts and circumstances should be considered in the determination of whether it is appropriate for an investor to consolidate if a decision maker does not have a variable interest.
7.2.7 Multiple Parties Involved in Decision Making (Step 3)

ASC 810-10

**25-38D** If a reporting entity determines that power is, in fact, shared among multiple unrelated parties such that no one party has the power to direct the activities of a VIE that most significantly impact the VIE’s economic performance, then no party is the primary beneficiary. Power is shared if two or more unrelated parties together have the power to direct the activities of a VIE that most significantly impact the VIE’s economic performance and if decisions about those activities require the consent of each of the parties sharing power. If a reporting entity concludes that power is not shared but the activities that most significantly impact the VIE’s economic performance are directed by multiple unrelated parties and the nature of the activities that each party is directing is the same, then the party, if any, with the power over the majority of those activities shall be considered to have the characteristic in paragraph 810-10-25-38A(a).

**25-38E** If the activities that impact the VIE’s economic performance are directed by multiple unrelated parties, and the nature of the activities that each party is directing is not the same, then a reporting entity shall identify which party has the power to direct the activities that most significantly impact the VIE’s economic performance. One party will have this power, and that party shall be deemed to have the characteristic in paragraph 810-10-25-38A(a).

The following flowchart illustrates how the party with the power to direct the most significant activities of the VIE is determined when multiple unrelated parties have power over the significant activities:

- **Is power over the activity or activities that most significantly affect the economic performance of the VIE considered shared?** (Section 7.2.7.1)
  - Yes: There is no primary beneficiary.
  - No: **Do multiple unrelated parties individually direct different significant activities?** (Section 7.2.7.2)
    - Yes: The party with power over the activity or activities that most significantly affect the economic performance of the VIE has the power to direct the activities of the VIE that most significantly affect the entity’s economic performance.
    - No: There is no primary beneficiary.
  - **Does one party have the power over the majority of the activity or activities in situations in which multiple unrelated parties are directing the same activity or activities?** (Section 7.2.7.2)
    - Yes: The party with power over a majority of the activity or activities has the power to direct the activities of the VIE that most significantly affect the VIE’s economic performance.
    - No: There is no primary beneficiary.
In the above flowchart, the party that is deemed to have power over the activity or activities that most significantly affect the economic performance of the VIE would be considered the primary beneficiary of the VIE if that party has a variable interest and the obligation to absorb losses of, or the right to receive benefits from, the VIE that could potentially be significant to the VIE.

### 7.2.7.1 Shared Power

In situations in which multiple unrelated parties are involved in making the decisions related to all the significant activities of a VIE and have shared power, a reporting entity would perform the power-criterion analysis differently than it would if the multiple unrelated parties had power over different activities. ASC 810-10-25-38D states that if power is truly shared among multiple unrelated parties, and no single party has the power to direct the activities that most significantly affect the VIE’s economic performance, there is no primary beneficiary unless a related-party relationship (including de facto agents) exists between the parties that share power. See Section 7.4.2.2 (related-party considerations associated with shared power) and Section 8.2 (identifying related parties). However, if multiple unrelated parties are responsible for different significant activities, power is not shared, and one entity will be the primary beneficiary (see Section 7.2.7.2).

The threshold for concluding that power is shared is high. Such a conclusion can only be reached if all decisions that significantly affect the VIE’s economic performance require consent of the parties with shared power. Specifically, all of the significant decisions must require consent.

In certain situations in which the consent of multiple parties is required for decisions, the governing documents may contain processes for resolving disagreements (e.g., deadlock provisions). It is important to consider whether any party is able to unilaterally break the deadlock in case of disagreement, for example by exercising a veto that results in final approval. In such instances, power will not be considered shared since this ability effectively allows that party to direct the VIE’s activity.

#### Example 7-3

Companies DD, RS, and BC form Entity MM to operate a marketing agency in New York and Los Angeles. Each company contributed cash in exchange for a 30 percent, 30 percent, and 40 percent equity interest, respectively, upon formation. The companies have no variable interests in MM other than their equity interests. Profits and losses are allocated and distributed among the equity holders in accordance with each equity holder’s respective ownership interest. Entity MM is a VIE because of insufficient equity investment at risk.

Each company appoints one board member to the board of directors. The board hires a management company (PC) to run the day-to-day operations of MM, but all significant decisions, including approval of the operating budget, must be approved by a majority vote of the board.

In this example, the investors do not have shared power because all of MM’s significant decisions require the consent of any combination of DD, RS, and BC. That is, the decisions about the significant activities do not require the consent of each of the parties. In addition, no party meets the power criterion, because no party has a majority of the voting interests.

Even if DD, RS, and BC were related parties (or de facto agents), control would still not be considered shared. Accordingly, they would not perform the related-party tiebreaker test, and a primary beneficiary would therefore not exist (see Section 7.4.2.2).
Example 7-4

Assume the same facts as in Example 7-3, except that all significant decisions must be approved by all members of the board of directors (rather than a majority of them). In this case, power would be considered shared because all significant decisions require the consent of the directors of all of the investors that are unrelated. Entity MM will not have a primary beneficiary because a single party does not have the power to direct the activities that most significantly affect MM's economic performance.

However, if DD, RS, and BC were related parties (or de facto agents), one party would be identified as the primary beneficiary since the related-party group collectively has power, and shared power cannot exist in a related-party group. The party that consolidates will be the party that is most closely associated with MM, on the basis of the related-party tiebreaker test (see Section 7.4.2.4).

7.2.7.2 Multiple Parties Performing the Same or Different Significant Activities

ASC 810-10-25-38E specifies that if multiple unrelated parties are responsible for different significant activities, and the decisions related to those activities do not require the consent of each party, a reporting entity with a variable interest must determine whether it has the power to direct the activities that have the most significant impact on the economic performance of the entity. One party must be identified as having power in these situations. Paragraph A56 of the Basis for Conclusions of Statement 167 states the FASB's belief that “as the number of activities of an entity increases, it will be more likely that one decision maker (or governing body) will exist or that decisions about those activities would require the consent of the [reporting entities] involved with the entity.”

Although ASC 810-10-25-38E specifically discusses unrelated parties, we believe that it also applies in the evaluation of whether a reporting entity, in a related-party group (in which multiple related parties are responsible for different significant activities, and the decisions related to those activities do not require the consent of each party), individually has the power to direct the activities that have the most significant impact on the economic performance of the entity. A reporting entity in a related-party group first evaluates whether it has individually met both the power criterion (Section 7.2) and the economics criterion (Section 7.3). See Section 7.4 for related-party considerations regarding the primary-beneficiary assessment.

Example 7-5

Assume the same facts as in Example 7-3, except that DD performs all activities related to the creative process, RS performs all activities related to the customer accounts, and BC performs all activities related to the operating and financing decisions. The decisions that require approval by the board of directors are those outside the ordinary course of business (e.g., admitting new investors). All other decisions are made by the respective investors responsible for the processes.

In this example, since multiple unrelated parties are responsible for different activities, and the decisions related to these activities do not require the consent of the other parties, one party will be the primary beneficiary because power is not shared. Determining which activity is the most significant to the economic performance of MM is necessary because the party that controls that activity will be the primary beneficiary.

If the facts in this example were to change such that each party were still responsible for different activities but all significant decisions regarding those activities still required unanimous consent of the board of directors, then power is shared and there would be no primary beneficiary.
When multiple unrelated parties are responsible for the same significant activity or activities that most significantly affect the economic performance of different portions of the VIE, and consent is not required, a party with power over the majority of the significant activity or activities (if such party exists) has power over the VIE. The determination of which party has power over the majority of the significant activities will require judgment and an evaluation of all facts and circumstances.

**Example 7-6**

Investors JX, CL, and OP are unrelated parties and together form Company SOA to operate charters in the northwest. Each investor contributed cash in exchange for a 60 percent, 20 percent, and 20 percent equity interest, respectively, upon formation. The investors do not have any variable interests in SOA other than their equity interests. Profits and losses are allocated and distributed among the equity holders on the basis of each equity holder’s respective ownership interest. SOA is a VIE because of insufficient equity investment at risk.

Company SOA has 10 charters that are similar in size and profitability. Investor JX is responsible for managing six charters, OP is responsible for managing three charters, and CL is responsible for managing the founding charter, with each charter representing approximately 10 percent of the total operations of SOA. Each charter has certain matters that require a vote of the respective charter’s members at the board table; however, these decisions are considered protective (e.g., opening a new line of business).

Since each party performs and directs the same activities (i.e., managing independent charters) without requiring consent of the other parties, the party with power over the majority of the significant activities has power over SOA. In this example, JX would be the primary beneficiary because it has power over six charters that represent a majority of the operations of SOA. The primary-beneficiary determination can be challenging when it is unclear whether one party has power over a majority of the activities, and all facts and circumstances should be carefully considered.

In situations in which two parties perform the same activities, it may be difficult to determine which party has power over a majority of the activities when it appears that both parties equally have power over 50 percent of the activities. Generally, unless the risks related to each party are identical (which is unlikely), one of the two parties must consolidate. However, as the number of parties directing the same activities increases, so does the likelihood that one single party will not have the power over a majority of the activities.

All types of power should be considered in the analysis of which party has the power to direct the activities that most significantly affect the economic performance of the VIE. In some cases, a party with multiple types of power may determine, when those powers are aggregated, that it is able to direct the activities that most significantly affect the economic performance of the VIE. This may occur in situations in which the parties involved with an entity have power over different significant activities and portions of the same significant activities. In these cases, a reporting entity must perform a detailed analysis (as illustrated in the examples in ASC 810-10-55-182 through 55-198) to determine whether its power over certain significant activities, along with its power over portions of other significant activities, identify it as having the power to direct the activities of the VIE that most significantly affect the VIE’s economic performance. For example, if Party A controls an activity that is deemed to significantly affect the economic performance of a VIE and Party B controls four activities, none of which individually affect the economic performance of the VIE as significantly as the activity directed by Party A, but that in the aggregate more significantly affect the economic performance of the VIE, Party B would have the power to direct the activities that most significantly affect the economic performance of the VIE.

In all the situations described above, to be considered the primary beneficiary, the party that has power must also have the obligation to absorb losses of the VIE or the right to receive benefits from the VIE that could potentially be significant to the VIE (see Section 7.3).
7.2.7.3 Some Unilateral Decisions and Some Decisions Requiring Consent

In certain situations, one party may unilaterally have power over one decision but another significant decision may require the consent of more than one party. For shared power to exist, all decisions regarding significant activities must require joint or unanimous consent. This view is consistent with that expressed in Chris Rogers’s speech at the 2014 AICPA Conference on Current SEC and PCAOB Developments. Mr. Rogers cited an example in which an entity that is owned equally by two unrelated parties has three significant activities. One entity unilaterally controls one activity, and the other two activities require joint consent by both parties. He stated:

In this example, while certain significant activities do require joint consent, it does not appear that shared power as described in [ASC] 810 exists. For shared power to exist, the guidance seems to suggest that all decisions related to the significant activities of the VIE require the consent of each party sharing power. When decisions related to a significant activity do not require joint consent, the staff has struggled to find a basis in the accounting literature to support that shared power can in fact exist. This is the case even when it is determined that the significant activities that require joint consent more significantly impact the economic performance of the entity than the significant activities that do not. In situations when shared power does not exist but multiple parties are directing different significant activities, the guidance provides that one party will meet the power criterion in the primary beneficiary assessment. The staff believes an extension of this principle suggests that the party with more power, relative to others, over the significant activities of the VIE should consolidate. In my example, a party’s shared decision making rights over certain significant activities along with its unilateral decision making rights over the remaining significant activity seems to provide that party with a greater ability to impact the economic performance of the VIE compared to the other owner and therefore it should consolidate the VIE. [Footnotes omitted]

Mr. Rogers highlighted the importance of performing the first step in a primary-beneficiary determination (i.e., determining which activities most significantly affect the VIE’s economic performance). In his example, all three activities were determined to be the activities that most significantly affected the VIE’s economic performance. He also noted that the conclusion in his example would be affected if a determination were made that the unilateral activity was not a significant activity, resulting in shared power over the two significant activities.

7.2.8 Substance of Power in Common-Control Groups (Step 3)

One party in a related-party group may appear to exhibit both characteristics of a controlling financial interest in ASC 810-10-25-38A. However, a closer evaluation of the substance of the party’s stated power and economic exposure is often necessary when a single party controls some or all parties in the related-party group, since that controlling party may have the ability to assign power or exposure to economics to a particular party to achieve a preferred consolidation result. A reporting entity should carefully consider the substance of the terms, transactions, and arrangements between the related parties and the parent company when evaluating whether substance (rather than the contractual form) indicates that one party in the related-party group should be deemed to have both of the characteristics of a controlling financial interest. The reporting entity should consider all relevant facts and circumstances in performing such an assessment.

At the 2014 AICPA Conference on Current SEC and PCAOB Developments, Chris Rogers addressed the concept of nonsubstantive power in common-control scenarios. He cautioned that although care should be taken in the identification of nonsubstantive power in common-control scenarios, related parties under common control do not always need to be evaluated under the related-party tiebreaker guidance:

The staff has received several questions recently regarding whether the related party tie-breaker guidance always must be considered when determining which party in a common control group is the primary beneficiary of a VIE. While common control arrangements do require careful consideration to determine if stated power is in fact substantive, the staff does not believe there is a requirement to consider the related party tie-breaker guidance or that guidance is necessarily determinative unless no party in the common control group individually meets both characteristics of a primary beneficiary. [Footnotes omitted]
In evaluating whether one party in a related-party group under common control should be deemed to have both of the characteristics of a controlling financial interest, a reporting entity may consider the factors in ASC 810-10-25-44(a)-(d). The purpose of considering these factors is not to determine whether consolidation of the VIE by one of the related parties under common control is required under the “most closely associated” guidance but rather whether these factors may be indicators that the substance of the arrangement should result in the consolidation of the VIE by one of the related parties.

For example, a legal entity may be designed so that the relationship and significance of its activities are related to one of the related parties in a common-control group and substantially all of the activities involve or are conducted on behalf of that same related party, but the stated power arrangement indicates that another party in the related-party group has power over the activities that most significantly affect the legal entity's economic performance. In such a scenario, the stated power may not be substantive.

See Section 7.4.2.4 for guidance on determining which party in a related-party group is most closely associated with a VIE.

7.2.9 Future Rights and Contingencies (Step 3)

7.2.9.1 Forward Starting Rights

Forward starting rights (such as call options and put options conveyed pursuant to contracts in existence as of the balance sheet date) are often central to the design of a VIE and therefore should not be disregarded in the primary-beneficiary analysis. While the existence of such rights, in isolation, may not be determinative in the identification of the party with power over the activities that are most significant to a VIE's economic performance, such rights often help a reporting entity understand the purpose and design of a legal entity and therefore may be useful in the primary-beneficiary determination.

Economic performance is a concept that involves the anticipated performance of the VIE over its remaining life. Accordingly, assessing power over the activities that most significantly affect a VIE's economic performance requires a consideration of all contractual rights and obligations during the VIE's remaining life, including those that are currently exercisable (such as a currently exercisable call option) and those that will arise in the future (e.g., a call option or a residual value guarantee on a leased asset at the end of the lease term) pursuant to contracts in existence on the evaluation date. Relevant considerations in both situations (i.e., currently exercisable rights and forward starting rights) may include the pricing of the feature (e.g., fixed exercise price or fair value exercise price and whether the option is in the money as of the evaluation date) and other business factors (e.g., whether a reporting entity holds a call option on an asset that is critical to its business operations).

Significant decisions often must be made over time about the strategic direction of traditional operating entities, and forward starting rights may, in the future, frequently shift the power over the strategic direction of those same activities from one variable interest holder to another (e.g., call options exercisable on a future date or other forward starting contracts). Decisions must also routinely be made about capital and resource deployment (or redeployment) because an operating entity is not always tied to a particular asset or business strategy. Consequently, significant power over current and future economic performance may be vested in the hands of the party with the substantive ability to make unilateral decisions about strategic or operating activities before the exercise or consummation of forward starting rights. That is, we believe that the VIE model is based on the notion of current power (i.e., which variable interest holder has the current power over significant activities) and generally should not take into account call options exercisable on a future date or other forward starting rights that transfer power in the future. Typically, call options or forward starting rights do not give a variable
interest holder a controlling financial interest in a traditional operating entity before the transfer of power. For example, as a result of its forward commitment to purchase the equity interests of a VIE that will provide control as of the closing date or at a point in time in the future after closing, a reporting entity generally would not have a controlling financial interest (and therefore would not apply acquisition accounting under ASC 805) until power transfers. However, all facts and circumstances should be considered, including whether a call option has a de minimis exercise price and substantively represents a kick-out right. A business combination (and a deconsolidation by the party transferring power) should not occur until the reporting entity obtains a controlling financial interest as of the date the forward starting right is exercised and there has been an effective transfer of power.

This concept applies to both (1) VIEs with a limited range of activities that are intended to operate over a finite life (e.g., single-lessee leasing entities) and (2) traditional operating entities that are VIEs and do not have a finite life. A finite life could be stipulated in the formation documents that establish the VIE or could be implied through the expected useful life of the asset or assets residing in the VIE. Although forward starting rights should be considered in the primary-beneficiary analysis of both types of VIEs, such rights (depending on their terms and the design of the entity) are more likely to have a meaningful impact on the analysis of VIEs whose life or range of activities is limited. The narrower scope of the significant activities of a VIE whose life or range of activities is limited is more likely to be considered in the VIE’s initial design.

Example 7-7

Entity A and Entity B each own 50 percent of the equity in Entity C, an operating entity. Entity A holds a future call right on B’s interest in C. However, B has the substantive ability to make strategically significant unilateral decisions until its interest is bought out. In this example, A’s future call right may not change the power analysis under ASC 810-10-25-38A. However, all facts and circumstances would need to be considered, including the pricing of the call option and other business factors.

Example 7-8

Entity A is created and financed to purchase a single property to be leased to Entity B for five years under an operating lease. Entity B must provide a first-loss residual value guarantee for the expected future value of the leased property at the end of the lease term and has a fixed-price purchase option to acquire the leased property at the end of the lease term. In accordance with its design, A will not buy or sell any other assets (i.e., A is a single-asset leasing entity). In this example, A was designed to provide B with the risks and rewards of ownership of the leased asset. Even though the purchase option is not exercisable until the end of the lease term, it is central to the design of A and would be considered in the primary-beneficiary analysis.

7.2.9.2 Contingencies

Future power can also be conveyed to a variable interest holder only upon the occurrence of a contingent event. Questions have arisen about whether such a variable interest holder can be the primary beneficiary of the VIE before the occurrence of that contingent event. When a party can direct activities only upon the occurrence of a contingent event, the determination of which party has power will require an assessment of whether the contingent event results in a change in power (i.e., power shifts from one party to another upon the occurrence of a contingent event) over the most significant activities of the VIE (in addition, the contingent event may change what the most significant activities of the VIE are) or whether the contingent event initiates the most significant activities of the VIE (i.e., the VIE’s most significant activities only occur when the contingent event happens). The former situation is illustrated in Example 7-9 below, the latter in Examples 7-10 and 7-11.
The determination of whether the contingent event results in a change in power over or initiates the most significant activities of the VIE will be based on a number of factors, including:

- The nature of the activities of the VIE and its design.
- The significance of the activities and decisions that must be made before the occurrence of the contingent event compared with the significance of the activities and decisions that must be made once the contingent event occurs. If both sets of activities and decisions are significant to the economic performance of the VIE, the contingent event results in a change in power over the most significant activities of the VIE. However, if the activities and decisions before the contingent event are not significant to the economic performance of the VIE, the contingent event initiates the most significant activities of the VIE.

If a reporting entity concludes that the contingent event initiates the most significant activities of the VIE, all of the activities of the VIE (including the activities that occur after the contingent event) would be included in the evaluation of whether the reporting entity has the power to direct the activities that most significantly affect the VIE's economic performance. In such instances, the party that directs the activities initiated by the contingent event would be the reporting entity with the power to direct the activities that most significantly affect the economic performance of the VIE.

If a reporting entity concludes that the contingent event results in a change in power over the most significant activities of the VIE, the reporting entity must evaluate whether the contingency is substantive. This assessment should focus on the entire life of the VIE. Some factors that a reporting entity may consider in assessing whether the contingent event is substantive include:

- The nature of the activities of the VIE and its design.
- The terms of the contracts the VIE has entered into with the variable interest holders.
- The variable interest holders' expectations regarding power at inception of the arrangement and throughout the life of the VIE.
- Whether the contingent event is outside the control of the variable interest holders of the VIE.
- The likelihood that the contingent event will occur (or not occur) in the future. This should include, but not be limited to, consideration of past history of whether a similar contingent event in similar arrangements has occurred.

If the contingent event is substantive, then the analysis of which party has power would not take into account decisions that would be made after the contingency is resolved until the contingency is actually resolved.

Further, assumptions about which activities will most significantly affect the economic performance of a VIE may change as the primary-beneficiary determination is continually reassessed. Any new assumptions should be considered upon such primary-beneficiary reconsiderations. Finally, a business combination or change in control would generally be considered a contingent event that results in a change in power over a VIE because the occurrence of those events represents a substantive contingency.
Example 7-9

Entity Heisenberg is formed by two investors (WW and JP) to develop and manufacture a new drug in New Mexico. Assume that Heisenberg is a VIE and that each investor holds a variable interest in Heisenberg. Investor WW has power over the research and development activities associated with the drug (stage 1) as well as obtaining FDA approval, and those activities most significantly affect Heisenberg’s economic performance during that stage. Investor JP has the power over the manufacturing process, distribution, and marketing of the drug (as well as protecting its patented formula) if and when FDA approval is obtained (stage 2), and those activities would most significantly affect Heisenberg’s economic performance during that stage. In determining which investor has the power to direct the activities that most significantly affect the economic performance of Heisenberg, each investor should assess whether the contingent event (FDA approval) results in a change in power over the most significant activities of Heisenberg (in addition, the contingent event may change what the most significant activities of Heisenberg are) or whether the contingent event initiates the most significant activities of Heisenberg.

Entity Heisenberg was designed such that there are two distinct stages during its life, and the variable interest holders expect that the second stage will only begin upon FDA approval. Also, the activities and decisions before and after FDA approval are significant to the economic performance of Heisenberg (in this example, they are different activities directed by different parties). In addition, the variable interest holders conclude that there is substantial uncertainty about whether FDA approval will be obtained and that the approval is outside their control. For these reasons, in the absence of evidence to the contrary, FDA approval would be considered a substantive contingent event that results in a change in power from WW to JP. Therefore, the primary-beneficiary determination should focus on stage 1 activities until the contingent event occurs, and WW (the investor that has power over the research and development activities) would initially have the power to direct the most significant activities of Heisenberg. If FDA approval is obtained, the primary-beneficiary determination would focus on stage 2 activities, and JP (the variable interest holder that has the power over the manufacturing process, distribution, and marketing of the drug) would have the power to direct the most significant activities of Heisenberg.

Example 7-10

Entity C, a VIE, is formed by Companies A and B to construct a power plant over the next three years. Entity C will subsequently operate the power plant throughout its useful life. Companies A and B have experience successfully constructing power plants with similar proven technology. Power over all construction decisions is shared by A and B, and A will unilaterally direct all of the significant activities after construction. Both of these actions are deemed to significantly affect the economic performance of C. Further, it was concluded that the decisions made after construction most significantly affect the economic performance of C.

In this example, although there are two phases (i.e., construction and operation), on the basis of historical experience, entry into the operation phase upon completion of the power plant is not a substantive contingent event. Therefore, the decisions made during construction and operations would be considered in the determination of which party meets the power criterion. Since decisions related to operations most significantly affect C’s economic performance and A unilaterally controls the operations of C, A would be deemed to have the power over the most significant activities.

By contrast, if C was intended to be built with unproven technology and was required to obtain significant regulatory approvals, and its ability to obtain those approvals was uncertain, the completion of construction could be considered a substantive contingent event. In that case, the initial power analysis would focus on the decisions during the construction phase.
Example 7-11

A VIE is created and financed with fixed-rate bonds and equity. All of the bonds are held by third-party investors. The VIE uses the proceeds to purchase commercial mortgage loans. The equity is held by a third party, which is also the special servicer. The transferor of the loans retains the primary servicing responsibilities. The primary servicing activities performed are administrative and include collection of payments on the loans and remittance to the interest holders, administration of escrow accounts, and collections of insurance claims. Upon delinquency or default by a borrower of a commercial mortgage loan, the responsibility for administration of the loan is transferred from the transferor (in this case, the primary servicer) to the special servicer. Furthermore, the special servicer, as the equity holder, has the approval rights for budgets, leases, and property managers of foreclosed properties. The special servicer concludes that the design of the VIE and the VIE’s governing documents allow the special servicer to adequately monitor and direct the performance of the underlying loans when necessary.

In this situation, the contingent event (delinquency or default by a borrower) initiates the activities that most significantly affect the economic performance of the VIE (i.e., the management of the VIE’s assets that are delinquent or in default). The activities and decisions made before delinquency or default by a borrower (the primary servicing responsibilities) are not significant to the economic performance of the VIE. Although the special servicing activities are performed only upon delinquency or default of the underlying assets, the special servicing activities are expected to most significantly affect the economic performance of the VIE and therefore the special servicer meets the power criterion. A reporting entity that has the power to direct the most significant activities of a VIE does not have to exercise that power.

7.2.10 Kick-Out Rights and Participating Rights

ASC 810-10

25-38C A reporting entity’s determination of whether it has the power to direct the activities of a VIE that most significantly impact the VIE’s economic performance shall not be affected by the existence of kick-out rights or participating rights unless a single reporting entity (including its related parties and de facto agents) has the unilateral ability to exercise those kick-out rights or participating rights. A single reporting entity (including its related parties and de facto agents) that has the unilateral ability to exercise kick-out rights or participating rights may be the party with the power to direct the activities of a variable interest entity that most significantly impact the entity’s economic performance. These requirements related to kick-out rights and participating rights are limited to this particular analysis and are not applicable to transactions accounted for under other authoritative guidance. Protective rights held by other parties do not preclude a reporting entity from having the power to direct the activities of a variable interest entity that most significantly impact the entity’s economic performance.

Kick-out rights can affect the power criterion and should be considered in the primary-beneficiary assessment only if the rights are held by a single party (and its related parties and de facto agents), can be exercised without cause, and are substantive. If these conditions are met, then the holder of the kick-out rights may be the party that meets the power criterion since it can remove the decision maker, managing member, or variable interest holder responsible for making the most significant decisions.

The ASC master glossary defines a kick-out right for a VIE as the “ability to remove the entity with the power to direct the activities of a VIE that most significantly impact the VIE’s economic performance or to dissolve (liquidate) the VIE without cause.” See Sections 7.2.10.1 through 7.2.10.3 for further discussion of kick-out rights.

Participating rights can also affect the power criterion and should be considered in the analysis, but as described below in Section 7.2.10.4, they will have a different impact on the power analysis than kick-out rights. The ASC master glossary defines participating rights as the “ability to block or participate in the actions through which an entity exercises the power to direct the activities of a VIE that most significantly impact the VIE’s economic performance. Participating rights do not require the holders of such rights to have the ability to initiate actions.”
7.2.10.1 Substantive Kick-Out Rights

For kick-out rights to be substantive, there cannot be any significant barriers to their exercise. Although it is in the general section of ASC 810-10, the guidance in ASC 810-10-25-14A notes that barriers to the exercise of kick-out rights include the following:

a. Kick-out rights subject to conditions that make it unlikely they will be exercisable, for example, conditions that narrowly limit the timing of the exercise
b. Financial penalties or operational barriers associated with dissolving (liquidating) the limited partnership or replacing the general partners that would act as a significant disincentive for dissolution (liquidation) or removal
c. The absence of an adequate number of qualified replacement general partners or the lack of adequate compensation to attract a qualified replacement
d. The absence of an explicit, reasonable mechanism in the limited partnership’s governing documents or in the applicable laws or regulations, by which the limited partners holding the rights can call for and conduct a vote to exercise those rights
e. The inability of the limited partners holding the rights to obtain the information necessary to exercise them.

A reporting entity should consider all relevant facts and circumstances — including the effect of related parties and de facto agents, which can be complex and difficult to understand — in determining whether kick-out rights are substantive. However, in the absence of a significant barrier to exercise, a kick-out right holder’s intent to not exercise that right does not preclude the kick-out right from being substantive.

7.2.10.2 Board of Directors Typically Is Not a Single Party

Because ASC 810-10-25-38C specifically states that kick-out rights can only be considered if they are held by a single party, questions have been raised about whether a board of directors could be considered a single party in the primary-beneficiary assessment. Typically, the board of directors is merely an extension of the reporting entity’s equity holders. A board is usually established to act solely in a fiduciary capacity for the equity holders and generally consists of more than one individual. The kick-out rights held by the board are essentially the kick-out rights shared by the equity holders who elected the board. Therefore, the board should not be considered a single party, and the kick-out rights held by the board should not be considered in the determination of whether a reporting entity is a VIE’s primary beneficiary. Similarly, a shell entity that serves as the feeder for the investments of multiple limited partners generally cannot be considered a single entity.

However, in certain situations, a single equity holder (or a related-party group of equity holders) may control representation on the board of directors (i.e., has more than 50 percent representation on a board requiring a simple majority vote, thereby indirectly controlling the board’s vote). In these situations, a kick-out right held by the board of directors, if substantive, may be considered a unilateral right of a single party.

Even though a board of directors generally may not be viewed as a single party in the determination of whether a single party holds a kick-out right, when the board has the ability to remove a decision maker, managing member, or other party that makes decisions, the board will often actually possess the power over the most significant activities. That is, the decision maker, managing member, or other party will be restricted from unilaterally controlling the most significant decisions by the governance at the board or shareholder level. See Section 7.2.5 for a discussion of how to determine whether the most significant activities are directed at the board level or at the manager level.
Liquidation rights are considered equivalent to kick-out rights and should be evaluated in a manner similar to kick-out rights in the determination of whether a party meets the power criterion. In paragraph BC49 of ASU 2015-02, the FASB explains that it “decided that liquidation rights should be considered equivalent to kick-out rights [because they] provide the holders of such rights with the ability to dissolve the entity and, thus, effectively remove the decision maker’s authority.”

Paragraph BC49 further indicates that the Board considered, but rejected, requiring reporting entities to evaluate liquidation rights in a manner similar to kick-out rights on the basis of the guidance in Statement 167 before ASU 2015-02. Such an evaluation would be performed “only when it is reasonable that upon liquidation, the investors will receive substantially all of the specific assets under management and can find a replacement manager with sufficient skills to manage those assets.” The Board stated that it “ultimately rejected this view because the outcome for the decision maker is the same regardless of whether the holders of those rights have the ability to obtain the specific assets from the entity upon liquidation or identify an alternative manager [because if] the holders exercise their substantive liquidation rights, similar to kick-out rights, the decision maker’s abilities would be removed.”

Therefore, any liquidation right should be considered a kick-out right and would affect the determination of the primary beneficiary and whether an entity is a VIE if the right (1) is substantive and (2) gives a single reporting entity (including its related parties and de facto agents) the unilateral ability to liquidate an entity. Paragraph BC49 also indicates that “[b]arriers to exercise may be different when considering kick-out rights as compared with barriers for liquidation rights and should be evaluated appropriately when assessing whether the rights are substantive.”

It is important to distinguish liquidation rights from withdrawal rights since ASC 810-10-25-14B indicates that a reporting entity’s unilateral right to withdraw from an entity that does not require dissolution or liquidation of the entire legal entity “would not be deemed a kick-out right.” A reporting entity should make this distinction on the basis of the specific facts and circumstances. A withdrawal right represents a liquidation right only if its exercise would result in the liquidation (or dissolution) of the entire entity. This may be the case when an entity has only a single investor, or an entity’s formation documents require the dissolution of the entity upon exercise of the withdrawal right (e.g., the exercise of the withdrawal right may result in a decline in the amount of the entity’s remaining assets to a level that triggers dissolution, and the dissolution cannot be prevented). Withdrawal rights that do not require the dissolution or liquidation of the entire entity do not represent liquidation rights and therefore should not be considered kick-out rights. Furthermore, when the exercise of a withdrawal right does require the dissolution or liquidation of the entire entity, the right should only affect the determination of the primary beneficiary if the right (1) is substantive and (2) gives a single reporting entity (including its related parties and de facto agents) the unilateral ability to liquidate a legal entity.

Special consideration is also necessary when a liquidation right (or a withdrawal right that represents a liquidation right) is exercisable in the future. In these situations, the right should be evaluated in the same manner as other forward starting rights. See Section 7.2.9.1 for a discussion of forward starting rights in a primary-beneficiary assessment. A reporting entity will need to use judgment to distinguish between forward starting liquidation rights that are not subject to a contingency (i.e., rights that are exercisable simply upon the passage of time) and forward starting liquidation rights whose exercise in the future depends upon the occurrence or nonoccurrence of a specified future event. The latter situation is discussed in Section 7.2.9.2.

As stated in ASC 810-10-25-14B, “[t]he requirement to dissolve or liquidate the entire limited partnership upon the withdrawal of a limited partner or partners shall not be required to be contractual for a withdrawal right to be considered as a potential kick-out right.” Therefore, a reporting entity must determine, on the basis of the facts and circumstances, whether the practical result of the withdrawal will be the required dissolution of the partnership (e.g., the partnership has only one limited partner and the general partner has a nominal interest) or its liquidation.
7.2.10.4 Participating Rights

In a manner similar to kick-out rights, participating rights are only considered in the primary-beneficiary assessment if the participating rights are held by a single party (and its related parties and de facto agents) and are substantive. The VIE definition of participating rights is different from the voting interest entity definition (see Table 1-1 in Section 1.4 for differences between the voting interest entity model and the VIE model).

To be deemed substantive, a participating right must allow the holder to block or participate in all of the activities that most significantly affect the VIE's economic performance. That is, a participating right will not be substantive if a VIE has three significant activities and the holder can only block decisions related to one of the three significant activities. Participating rights are contrasted with protective rights, which are designed to protect the interests of a party (see Section 2.7 for the VIE definition of protective rights).

If deemed substantive and unilaterally exercisable, the participating right prevents another party from having power. However, unlike kick-out rights, a participating right does not convey power to the holder of the substantive participating right because it only allows the holder to block or participate in decisions as opposed to make decisions.

For entities other than limited partnerships, the evaluation of participating rights in the primary-beneficiary assessment is consistent with the evaluation of participating rights in the determination of whether the equity holders have power in the VIE assessment. In other words, for entities other than limited partnerships, the VIE definition of participating rights is used for both the VIE and the primary-beneficiary assessment. However, for limited partnerships, the VIE definition is used for the primary-beneficiary assessment whereas the voting interest entity definition is used for determining whether the equity holders have power in the VIE assessment. See Section 5.3.1.1.3.5 for a discussion of the effect of substantive participating rights on the VIE assessment under the VIE definition of participating rights for entities other than partnerships. See Section 5.3.1.2.7 for a discussion of the effect of substantive participating rights on the VIE assessment for limited partnerships.

7.3 Economics Criterion

7.3.1 General Framework

To satisfy the economics criterion in the analysis of the primary beneficiary of a VIE, the variable interest holder must have the obligation to absorb losses of the VIE, or the right to receive benefits from the VIE, that could potentially be significant to the VIE. This analysis is different from determining whether an equity investment is “at risk,” which includes only equity investments in the legal entity that participate significantly in both profits and losses. Said simply, the variable interest holder must have an exposure to the economics (benefits or losses) of the VIE that is more than insignificant.
ASC 810-10-25-38A(b) states that the reporting entity need not perform a quantitative analysis related to expected losses, expected residual returns, or expected variability in evaluating whether the economics criterion has been met and that, in fact, the results of such an analysis should not be the sole determinant. In addition, the FASB deliberately omitted bright-line tests from the guidance because it believed that the assessment should focus on qualitative factors. Paragraph BC56 of ASU 2015-02 states, in part:

This is a qualitative assessment based on all facts and circumstances and the purpose and design of the VIE. At the time Statement 167 was issued, the Board did not want to provide bright-line guidance related to this assessment. Paragraph A41 of the basis for conclusions in Statement 167 states the following:

The Board . . . decided not to provide additional guidance on whether an enterprise’s obligation to absorb losses or its right to receive benefits could potentially be significant to the variable interest entity. The Board emphasized that determining whether an enterprise has the obligation to absorb losses or the right to receive benefits that could potentially be significant to a variable interest entity would require judgment and consideration of all facts and circumstances about the terms and characteristics of the variable interest(s), the design and characteristics of the variable interest entity, and the other involvements of the enterprise with the variable interest entity. . . . However, the Board decided not to provide an analysis of how an enterprise concluded whether it had the obligation to absorb losses or the right to receive benefits that could potentially be significant to the variable interest entity. The Board believes that any such analysis would inevitably serve as the establishment of “bright lines” that would be used in practice as the sole factor when determining whether such obligations or rights could potentially be significant to a variable interest entity.

In some limited cases, a reporting entity can conclude that a quantitatively significant interest does not meet the economics criterion on the basis of qualitative factors and an overall consideration of the reporting entity’s quantitative and qualitative assessments. While it may be appropriate in some circumstances, such a conclusion should be carefully considered since paragraph A39 in the Basis for Conclusions of Statement 167 states that “obligations or rights that could potentially be significant often identify the enterprise that explicitly or implicitly has the power to direct the activities that most significantly impact the economic performance of a [VIE].”

A reporting entity may also conclude qualitatively that an interest meets the economics criterion without performing any detailed quantitative calculations. For example, if a decision maker holds 100 percent of the residual interest in an entity (and the residual interest is substantive), the reporting entity may conclude that it does not need to perform a quantitative test (i.e., the reporting entity could qualitatively conclude, on the basis of specific facts and circumstances, that holding all of a substantive residual interest would result in the reporting entity’s absorption [receipt] of more than an insignificant amount of the entity’s losses [benefits]).
A consideration of qualitative factors in conjunction with quantitative factors is consistent with remarks made by the SEC staff at the 2009 AICPA Conference on Current SEC and PCAOB Developments. The SEC staff noted that assessing significance requires reasonable judgment and should be based on the total mix of information, including both quantitative and qualitative factors. An SEC staff member, Professional Accounting Fellow Arie Wilgenberg, gave the following examples of qualitative factors that could be considered:

1. The purpose and design of the entity. What risks was the entity designed to create and pass on to its variable interest holders?

2. A second factor may be the terms and characteristics of your financial interest. While the probability of certain events occurring would generally not factor into an analysis of whether a financial interest could potentially be significant, the terms and characteristics of the financial interest (including the level of seniority of the interest), would be a factor to consider.

3. A third factor might be the enterprise’s business purpose for holding the financial interest. For example, a trading desk employee might purchase a financial interest in a structure solely for short-term trading purposes well after the date on which the enterprise first became involved with the structure. In this instance, the decision making associated with managing the structure is independent of the short-term investment decision. This seems different from an example in which a sponsor transfers financial assets into a structure, sells off various tranches, but retains a residual interest in the structure.

In assessing whether the economics criterion has been met, a reporting entity should perform the following steps:

- **Step 1** — The reporting entity should consider the risks that the VIE was designed to create and pass through to its variable interest holders and identify any loss or benefit scenarios that could arise for the VIE from those risks. In performing this step, the reporting entity should not consider probability; rather, the reporting entity should focus on identifying all scenarios that are consistent with the VIE’s design.

- **Step 2** — For each scenario identified in step 1, the reporting entity should evaluate the extent to which its interest would absorb losses of the VIE or receive benefits from the VIE. A reporting entity would generally meet the economics criterion if it concluded that the amount of losses its interest would absorb, or the amount of benefits its interest would receive, in any of the identified scenarios would be significant relative to the VIE’s performance in those scenarios, even if the level of losses incurred or benefits generated by the VIE in the scenarios are not quantitatively significant to the VIE.

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**Example 7-12**

Entity A is designed to hold a diverse portfolio of high-credit-quality, short-term bonds. To mitigate credit risk, A obtains a financial guarantee (from Reporting Entity B) designed to absorb any credit losses on the bond portfolio. The financial guarantee is a variable interest in A and is provided by a single reporting entity. Entity A is financed with debt securities that receive a pass-through of the interest earned on the underlying bond portfolio less any fees paid to the financial guarantor. The debt securities issued by A are widely dispersed.

To evaluate whether B meets the economics criterion, it would first consider the risks that A was designed to create and pass through to its variable interest holders (credit risk in this example) and identify any scenarios that would generate losses or benefits for A on the basis of those risks. Even if the absolute amount of losses or benefits that arise in A is expected to be insignificant to A, B would absorb a significant amount of the losses or benefits of A in any of those scenarios and would generally meet the economics criterion.
7.3.2 Probability Not Considered

When determining whether it meets the economics criterion, a reporting entity should not consider probability. Therefore, even a remote possibility that a reporting entity could absorb losses or receive benefits that could be significant to the VIE would typically cause the reporting entity to meet the economics criterion. However, in general, the more remote this possibility is, presumably the less likely it will be that the risks or rewards are related to the risks the VIE was designed to create and pass along to its variable interest holders. In other words, in the determination of whether the economics criterion has been met, it is important not to put undue emphasis on a “potential” risk that is not one of the significant risks the VIE was designed to create and pass along to its interest holders.

Example 7-13

Entity X is the general partner of XYZ Partnership, a limited partnership whose purpose is to acquire real estate properties to lease to individuals. Entity X's general partner interest is nominal, and it does not have any limited partner interests. As the general partner, Entity X is required under partnership law to assume the general liability risks associated with the partnership. In addition, as general partner, X makes all the significant decisions related to the real estate assets.

Although X is subject to the general liability risks of the partnership, those risks may not be relevant to the purpose and design of the VIE and therefore should be considered carefully in the determination of whether the economics criterion has been met. For example, the risk that someone slips and falls may be the responsibility of the general partner. However, the probability of that event's occurrence is remote and, since the purpose and design of the partnership was not to pass along such risks to the variable interest holders, X should not focus on that risk in determining whether the economics criterion has been met.

Given the requirement to consider all possible scenarios regardless of the likelihood of their occurrence, a reporting entity will generally not need to perform a detailed quantitative calculation to determine whether a variable interest represents a potentially significant interest. That is, the determination can generally be made on the basis of the design of the VIE and the contractual terms of the reporting entity's variable interest(s).

Note that determining whether the economics criterion has been met is different from analyzing how other interests affect whether a fee is a variable interest under ASC 810-10-55-37(c). Specifically, the consideration of the probabilities of various outcomes is important in the determination of whether a decision-maker or service-provider fee is a variable interest. While the “significant” threshold is used in both assessments, the evaluation of a decision maker’s economic exposure under ASC 810-10-25-38A(b) focuses on whether the reporting entity's economic exposure could be more than insignificant. Therefore, unless the condition in ASC 810-10-55-37(c) is not met solely as a result of an indirect interest held by the decision maker in an entity under common control that would not be considered significant if assessed on a proportionate basis (see Section 7.3.5.1), it would be unusual for the decision maker to not meet the economics criterion.

7.3.3 Definition of “Insignificant”

Although the FASB does not define “insignificant” in ASC 810-10, paragraph A75 of the Basis for Conclusions of Statement 167 states that the FASB used the term “insignificant” instead of “more than trivial” because the latter has been interpreted in practice to mean a very small amount (i.e., anything other than zero) and “no evaluation of the facts and circumstances related to the interest or the [reporting entity’s] involvement with the [VIE] is considered when making this determination.”

As a general guideline, the economics criterion would be met if the losses or returns absorbed through the reporting entity's variable interests in the VIE exceed, either individually or in the aggregate, 10
percent of the losses or returns of the VIE under any scenario (see Section 7.3.2). However, 10 percent
should not be viewed as a bright-line or safe harbor definition of “insignificant.” That is, as a result of
facts and circumstances, a reporting entity may conclude that the economics condition is met even if
the losses or returns absorbed by the reporting entity's interests in the VIE are less than 10 percent.
For example, a reporting entity that is the decision maker may hold 9 percent of the equity interests in
a VIE, but the VIE's governing documents may specifically require the decision maker to hold that much
equity to possess the power to direct the activities that most significantly affect the VIE's economic
performance (i.e., the investors demanded the decision maker have an economic principal investment
that is aligned with their interests). That qualitative factor may indicate that the 9 percent interest is
potentially significant.

These considerations will require the application of professional judgment and an assessment of the
nature of the reporting entity's involvement with the VIE.

7.3.4 Decision-Maker and Service-Provider Fees

ASC 810-10

25-38H For purposes of evaluating the characteristic in paragraph 810-10-25-38A(b), fees paid to a reporting
entity (other than those included in arrangements that expose a reporting entity to risk of loss as described in
paragraph 810-10-25-38J) that meet both of the following conditions shall be excluded:

a. The fees are compensation for services provided and are commensurate with the level of effort required
to provide those services.
b. The service arrangement includes only terms, conditions, or amounts that are customarily present in
arrangements for similar services negotiated at arm's length.

25-38I Facts and circumstances shall be considered when assessing the conditions in paragraph 810-10-25-
38H. An arrangement that is designed in a manner such that the fee is inconsistent with the reporting entity's
role or the type of service would not meet those conditions. To assess whether a fee meets those conditions,
a reporting entity may need to analyze similar arrangements among parties outside the relationship being
evaluated. However, a fee would not presumptively fail those conditions if similar service arrangements did not
exist in the following circumstances:

a. The fee arrangement relates to a unique or new service.
b. The fee arrangement reflects a change in what is considered customary for the services.

In addition, the magnitude of a fee, in isolation, would not cause an arrangement to fail those conditions.

25-38J Fees or payments in connection with agreements that expose a reporting entity (the decision maker or
service provider) to risk of loss in the VIE shall not be eligible for the evaluation in paragraph 810-10-25-38H.
Those fees include, but are not limited to, the following:

a. Those related to guarantees of the value of the assets or liabilities of a VIE
b. Obligations to fund operating losses
c. Payments associated with written put options on the assets of the VIE
d. Similar obligations such as some liquidity commitments or agreements (explicit or implicit) that protect
holders of other interests from suffering losses in the VIE.

Therefore, those fees shall be considered for evaluating the characteristic in paragraph 810-10-25-38A(b).
Examples of those variable interests are discussed in paragraphs 810-10-55-25 and 810-10-55-29.
7.3.4.1 “Commensurate” and “At-Market” Exclusions

The economics criterion did not change significantly as a result of the amendments in ASU 2015-02. However, fees paid to a VIE’s decision maker or service provider are not considered in the evaluation of the economics criterion, regardless of whether the reporting entity has other economic interests in the VIE, if the fees (1) are “commensurate” and “at market” (see Section 4.4.1 for a discussion of determining whether the fees meet these criteria) and (2) do not expose the reporting entity to the risk of loss (see Section 7.3.4.2). Paragraph BC42 of ASU 2015-02 describes the Board’s rationale for excluding these fees in the economics-criterion evaluation as follows:

The basis for the Board’s decision was that service arrangements that meet the conditions in paragraph BC40 are inherently different from other types of variable interests and, therefore, should not be considered for evaluating the economics criterion of a primary beneficiary. That type of compensation does not subject the reporting entity to risk of loss, unlike capital investments or guarantees. The risk associated with compensation that meets those conditions exposes a decision maker only to opportunity costs of the nonreceipt of fees and not exposure to losses and, therefore, reflects an agency or fiduciary role. The Board acknowledged that upside and downside risks are inextricably linked and that the opportunity to receive a benefit is always accompanied with risk. In essence, the Board gave greater priority to variable interests that provide both benefits and losses or only losses when evaluating the characteristic in paragraph 810-10-25-38A(b).

Example 7-14

Entity A manages a fund in exchange for a fixed annual fee equal to 250 basis points of assets under management. Entity A determined that the commensurate fee for the management services was only 150 basis points. Since A’s fees are not commensurate, A has a variable interest and must include the entire fee (i.e., 250 basis points) in its analysis under the economics criterion.

7.3.4.2 Exposure to Risk of Loss

Not all fees that are commensurate and at market can be excluded from the evaluation of whether the economics criterion has been met. If the fee arrangement is designed to expose a reporting entity to risk of loss in the potential VIE (e.g., a guarantee), the fees will be included in the reporting entity’s economics-criterion evaluation. In paragraph BC43 of ASU 2015-02, the FASB explained that a fee arrangement that exposes a reporting entity to risk of loss in a potential VIE should never be eligible for exclusion from the evaluation of whether (1) the reporting entity has met the economics criterion or (2) a decision-making arrangement is a variable interest. This serves as a safeguard to ensure that, if a fee arrangement is structured as a means to absorb risk of loss that the reporting entity was designed to pass on to its variable interest holders, the arrangement will be included in the consolidation analysis. Therefore, even if such fees are otherwise commensurate and at market, they would not be eligible for exclusion from the economics-criterion evaluation.

Accordingly, a reporting entity should carefully consider the design of the potential VIE to determine whether the related exposure that the fee arrangement absorbs is a risk that the reporting entity was designed to pass on to its variable interest holders. For example, the fee arrangement may be substantially a fee-for-service contract and have certain protections that are customary and standard, but it may not expose the decision maker or service provider to any of the primary risks of the potential VIE. In this case, the fees received are not designed as compensation for exposure to risk of loss in the potential VIE and would be eligible for exclusion from the economics-criterion evaluation.

While fees received as compensation for providing loss protection to the reporting entity are typically easy to identify, reporting entities must carefully consider all the facts and circumstances associated with fee structures that are designed to reduce or eliminate losses that would otherwise accrue to the holders of the reporting entity’s variable interests.
Example 7-15

Entity A enters into an arrangement with an unrelated party to manage the operations of a VIE with a single real estate asset for an annual fee of $120,000. However, the fee arrangement also contains a provision that requires A to pay $50,000 to the VIE for each month that the real estate asset is less than 70 percent occupied. Accordingly, if the real estate asset had occupancy of less than 70 percent for the full year, A would be required to pay the VIE $600,000. While the fee appears to have been negotiated at arm’s length with an unrelated party, A has effectively protected the holders of other interests in the VIE from suffering losses in the VIE. Therefore, A would have a variable interest, and the entire fee, as well as the maximum exposure to loss, must be included in A’s evaluation of whether it satisfies the economics criterion.

7.3.4.3 Fees Included in Economics-Criterion Evaluation

If a decision maker’s or service provider’s fee is not commensurate or at market, the reporting entity must include the entire fee in its assessment of whether it has met the economics criterion, not just the amount of the fee that is above or below the commensurate amount. Further, if there are other elements or benefits embedded in the fee arrangement, the reporting entity should evaluate them to determine how they could affect its risk exposure.

Example 7-16

Entity A transfers loans into a securitization trust and retains the right to unilaterally perform the servicing function, which represents the activities that most significantly affect the economic performance of the trust. Entity A receives annually 10 basis points of the unpaid principal balance for performing the services (A did not receive any off-market proceeds from the securitization or enter into other arrangements with the trust). Entity A determines that 30 basis points is commensurate and therefore recognizes a servicing liability upon transfer. Since the fees it receives are not commensurate, A has a variable interest and must include the fees in its analysis under the economics criterion. Entity A would also need to assess whether there are any other benefits or elements embedded in the fee arrangement (i.e., whether the below-market fee represents an obligation to absorb significant losses) that could potentially be significant.

In analyzing whether a fee, such as the one described in Example 7-14, that is not commensurate or at market meets the economics criterion, the reporting entity should consider paragraph A42 of Statement 167, which stated, in part:

The Board also reasoned that a service provider’s right to receive a fixed fee, in and of itself, would not always represent an obligation or a benefit that could potentially be significant to the variable interest entity. For example, the Board observed that a servicer of an entity’s loans may be paid a fee that is a fixed percentage of the balance of the loans. In that case, the servicer may be able to conclude, on the basis of the magnitude of the fixed percentage, that the fee could not ever potentially be significant to the entity because the fee would remain a constant percentage of the entity’s assets.
7.3.5 Assessing Whether a Single Decision Maker Meets the Economics Criterion

ASC 810-10

25-42 Single Decision Maker — The assessment in this paragraph shall be applied only by a single reporting entity that meets the characteristic in paragraph 810-10-25-38A(a). For purposes of determining whether that single reporting entity, which is a single decision maker, is the primary beneficiary of a VIE, the single decision maker shall include all of its direct variable interests in the entity and, on a proportionate basis, its indirect variable interests in the entity held through related parties (the term related parties in this paragraph refers to all parties as defined in paragraph 810-10-25-43). For example, if the single decision maker owns a 20 percent interest in a related party and that related party owns a 40 percent interest in the entity being evaluated, the single decision maker’s indirect interest in the VIE held through the related party would be equivalent to an 8 percent direct interest in the VIE for purposes of evaluating the characteristic in paragraph 810-10-25-38A(b) (assuming it has no other relationships with the entity). Similarly, if an employee (or de facto agent) of the single decision maker owns an interest in the entity being evaluated and that employee’s (or de facto agent’s) interest has been financed by the single decision maker, the single decision maker would include that financing as its indirect interest in the evaluation. For example, if a single decision maker’s employees have a 30 percent interest in the VIE and one third of that interest was financed by the single decision maker, then the single decision maker’s indirect interest in the VIE through the financing would be equivalent to a 10 percent direct interest in the VIE.

When evaluating whether a single decision maker that meets the power criterion also meets the economics criterion, the reporting entity must consider its direct interests and indirect interests (i.e., those held through its related parties and de facto agents) in the VIE. If the single decision maker meets the economics criterion through its direct interests, it is not necessary to further consider its indirect interests. The reporting entity would only consider its related party’s or de facto agent’s interests in the determination of whether it has met the economics criterion if the reporting entity has an interest in the related party. If the reporting entity does not have a direct interest in the related party, it would not be appropriate to attribute the related party’s interests to the reporting entity. Interests held through related parties are included in the economics criterion determination on a proportionate basis when the reporting entity has a direct interest in the related parties (see Sections 7.3.5.1 and 7.3.5.2).

However, it may not always be apparent whether a reporting entity holds a variable interest in its related party, because a reporting entity may not have a direct interest in the related party but may be implicitly exposed to the related party’s interest in the VIE. A reporting entity should evaluate all arrangements (whether explicit or implicit) between parties to determine whether a variable interest exists when (1) the reporting entity’s related parties have entered into transactions on behalf of the reporting entity and (2) the reporting entity otherwise would have consolidated the VIE if it was determined to have a direct or explicit variable interest in the VIE. See Section 4.3.10 for a detailed discussion of implicit variable interests.
Example 7-17

Company A is the general partner of a VIE with a 2 percent equity interest and the ability to make the most significant decisions. Company A receives a separate fixed fee and an incentive fee that are commensurate and at market. Companies B, C, and D are limited partners in the VIE with a 29 percent, 29 percent, and 40 percent partnership interest, respectively. Company A has a 40 percent investment in D that is accounted for under the equity method. Companies B and C are unrelated to A.

In assessing whether it meets the economics criterion, A can exclude its fees since they are commensurate and at market; however, A must include its 2 percent direct interest and its 16 percent (40 percent × 40 percent) indirect interest held through its related party (D). As a result, A’s total economic exposure is 18 percent, which is potentially significant to the VIE. Accordingly, A will be the primary beneficiary of the VIE because A also has the power to make the decisions that most significantly affect the VIE’s economic performance.

In this example, if A did not have the 40 percent equity interest in D, but the two entities were still deemed related parties, A would not have an indirect interest to include in its economics-criterion assessment because A does not have an interest in D.

Example 7-17A

GP (Service Provider) owns 20 percent of CLO Fund. The remaining 80 percent is owned by unrelated Third Party LPs. CLO Fund owns a 30 percent residual interest in CLO Subsidiary. GP (Service Provider) has a management agreement with, and acts as the decision maker for, CLO Subsidiary. Under the agreement, it receives fees that are deemed commensurate and at market.

Both CLO Fund and CLO Subsidiary have been deemed VIEs because neither have substantive participating rights or kickout rights. Assume that GP (Service Provider) has power over the CLO Fund which, in conjunction with GP (Service Provider)’s 20 percent equity interest in CLO Fund, results in the consolidation of CLO Fund by GP (Service Provider).

Because GP (Service Provider) consolidates CLO Fund, CLO Fund’s 30 percent residual interest in CLO Subsidiary represents a direct interest of GP (Service Provider) in CLO Subsidiary (i.e., it is not considered an indirect interest that would be assessed on a proportionate basis). Consequently, GP (Service Provider) would be the primary beneficiary of CLO Subsidiary since (1) the GP (Service Provider) management agreement represents a variable interest in CLO Subsidiary and provides GP (Service Provider) with power over CLO Subsidiary and (2) CLO Fund’s 30 percent residual interest in CLO Subsidiary, which represents a 30 percent direct interest in CLO Subsidiary for GP (Service Provider), meets the economics criterion.
If, after including interests held through related parties, the reporting entity does not exhibit both characteristics of a primary beneficiary, the reporting entity would still need to consider the related-party tiebreaker guidance in ASC 810-10-25-44A. In accordance with that guidance, in situations in which a reporting entity concludes that it does not individually have a controlling financial interest in a VIE, but the reporting entity and one or more of its related parties under common control, as a group, have the characteristics of a controlling financial interest, the party most closely associated with the VIE must consolidate the VIE. See Section 7.4.2.

7.3.5.1 Consideration of Interests Held by Entities Under Common Control

In evaluating whether the economics criterion has been met, a reporting entity would only consider interests held by its related parties (including de facto agents) under common control if the decision maker has a direct interest in those related parties. See Sections 2.11.2 and 8.2.2 for further discussion of what is meant by “common control.”

If the decision maker does not hold an interest in the related party under common control, it would not include any of the related party’s interests in its evaluation. Accordingly, if the decision maker meets the power criterion through its fee arrangement but does not meet the economics criterion, and, as a result of the aggregation of the decision maker’s interests with those of entities under common control, the related-party group meets the economics criterion, the decision maker would also need to consider the related-party tiebreaker guidance (see Section 7.4.2). Note that application of the related-party tiebreaker guidance in this instance should be rare because it is unlikely that the decision maker will not, on its own, meet both the power and economics criteria if it determines that it has a variable interest through the fee arrangement (see Section 7.4.2.3).

A reporting entity now considers its indirect economic interests in a VIE held through related parties under common control on a proportionate basis, in a manner consistent with indirect economic interests held through related parties not under common control (see Section 7.3.5.2). As stated in the Roadmap’s Introduction, the related-party tiebreaker test will be performed more frequently as a result of ASU 2016-17 (see Section 7.4.2.3) because it is less likely that decision makers will meet the economics criterion on their own when considering their exposure through a related party under common control on a proportionate basis.

Many decision makers view the amended guidance favorably because they would otherwise consolidate a legal entity with a small indirect interest. For example, a single decision maker of a fund could have a 2 percent interest in a related party under common control that holds a 20 percent interest in the fund. Under GAAP before ASU 2016-17, the single decision maker would consolidate even though it only holds less than 1 percent in the fund on a proportionate basis. The amendment instead requires the decision maker to consider which party (the single decision maker or the related party under common control) is the most closely associated with the fund and therefore should consolidate.
Example 7-18

Subsidiary A and Subsidiary B are under common control, and A owns 5 percent of B. Subsidiary A is the general partner (decision maker) for Partnership C, but it does not have any other interests in C. Subsidiary B owns 30 percent of C's limited partner interests. The partnership is considered a VIE. Assume that A's fixed fee arrangement is a variable interest because it does not meet the conditions in ASC 810-10-55-37(a) and (d). The fixed fee arrangement meets the criteria in ASC 810-10-55-37(c).

Under the guidance in ASC 810-10-25-42, when A and B evaluate whether they are the primary beneficiary of C (and therefore are required to consolidate C), each must first consider only its own respective interests in the VIE.

Accordingly, A would conclude that it meets the power criterion on its own. However, in the evaluation of the economics criterion, since A owns a 5 percent interest in B, and B owns a 30 percent interest in C, A's interest would be considered equivalent to a 1.5 percent indirect interest in C plus the entire fixed fee arrangement because the arrangement does not meet the conditions in ASC 810-10-55-37(a) and (d). Therefore, A would not meet the economics criterion on its own. Since A meets the power criterion, and B, its related party under common control, meets the economics criterion, A and B would need to perform the related-party tiebreaker test to determine which party is most closely associated with the VIE (see Section 7.4.2.3).

7.3.5.2 Aggregation of Interests Held by Related Parties Not Under Common Control

In a manner similar to entities under common control, a decision maker would only consider interests held by its related parties in its economics-criterion evaluation when it has an interest in those related parties. If the decision maker does not hold an interest in its related parties, it would not include any of its related-party interests in its evaluation. If the decision maker has a direct interest in the related parties, it should include its indirect interests held through its related parties (or de facto agents) on a proportionate basis.

Example 7-19

A collateral manager owns a 20 percent interest in a related party that is not under common control, and the related party owns 40 percent of the residual tranche of the CFE being evaluated. In this case, the collateral manager's interest would be considered equivalent to an 8 percent direct interest in the residual tranche of the CFE. Therefore, in addition to considering its own direct interest (if any), the collateral manager should include its 8 percent indirect interest in its assessment of whether its fee arrangement is a variable interest in the CFE and, if so, whether the collateral manager is the primary beneficiary of the CFE. However, if the collateral manager did not hold the 20 percent interest in its related party, it would not include any of the related party's interest in either evaluation.
7.4 Related-Party Considerations in the Primary-Beneficiary Assessment

7.4.1 Overview

In performing the primary-beneficiary analysis, a reporting entity must carefully consider related-party relationships. A reporting entity that concludes individually that it has not met both the power criterion (Section 7.2) and the economics criterion (Section 7.3) may still be required to consolidate a VIE as a result of combined interests that it holds with its related parties. In addition, the term “related parties” includes certain other parties that are acting as de facto agents or de facto principals of the reporting entity. Their interests are treated similarly to related-party interests in the performance of the primary-beneficiary portion of the VIE analysis (see Section 8.2 for a discussion of the identification of related parties). Accordingly, it is essential for reporting entities to correctly identify those entities that are related parties and appropriately consider their interests when performing the primary beneficiary assessment.

The discussion below outlines circumstances in which consolidation is required by one of the reporting entities in a related-party group, even if that reporting entity has individually concluded that it has not met both the power criterion and the economics criterion on its own. Note, however, that the related party’s interests should have also been considered in the evaluation of whether a single decision maker, on its own, meets the economics criterion (see Section 7.3.5).

7.4.2 Related-Party Tiebreaker Test and “Substantially All” Characteristic

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| **25-44** The guidance in this paragraph shall be applicable for situations in which the conditions in paragraph 810-10-25-44A have been met or when power is shared for a VIE. In situations in which a reporting entity concludes that neither it nor one of its related parties has the characteristics in paragraph 810-10-25-38A but, as a group, the reporting entity and its related parties (including the de facto agents described in paragraph 810-10-25-43) have those characteristics, then the party within the related party group that is most closely associated with the VIE is the primary beneficiary. The determination of which party within the related party group is most closely associated with the VIE requires judgment and shall be based on an analysis of all relevant facts and circumstances, including all of the following:
| 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 VIE to the various parties within the related party group  
| c. A party’s exposure to the variability associated with the anticipated economic performance of the VIE  
| d. The design of the VIE.  
| **25-44A** In situations in which a single decision maker concludes, after performing the assessment in paragraph 810-10-25-42, that it does not have the characteristics in paragraph 810-10-25-38A, the single decision maker shall apply the guidance in paragraph 810-10-25-44 only when the single decision maker and one or more of its related parties are under common control and, as a group, the single decision maker and those related parties have the characteristics in paragraph 810-10-25-38A. |
This paragraph applies to a related party group that has the characteristics in paragraph 810-10-25-38A only when both of the following criteria are met. This paragraph is not applicable for legal entities that meet the conditions in paragraphs 323-740-15-3 and 323-740-25-1.

a. The conditions in paragraph 810-10-25-44A are not met by a single decision maker and its related parties.

b. Substantially all of the activities of the VIE either involve or are conducted on behalf of a single variable interest holder (excluding the single decision maker) in the single decision maker’s related party group.

The single variable interest holder for which substantially all of the activities either involve or are conducted on its behalf would be the primary beneficiary. The evaluation in (b) above should be based on a qualitative assessment of all relevant facts and circumstances. In some cases, when performing that qualitative assessment, quantitative information may be considered. This assessment is consistent with the assessments in paragraphs 810-10-15-14(c)(2) and 810-10-15-17(d)(2).

A reporting entity is always required to assess whether it individually meets both characteristics (the power criterion and the economics criterion) of a primary beneficiary after considering the aggregation guidance discussed in Section 7.3.5. If a reporting entity concludes that it does not meet the criteria for a primary beneficiary but that the related-party group (including de facto agents) meets the criteria as a group, the reporting entity may be required to determine which party is most closely associated with the VIE and is required to consolidate the VIE. This determination requires the application of judgment and an evaluation of all relevant facts and circumstances, including the factors listed in ASC 810-10-25-44. Section 7.4.2.1 discusses situations in which a reporting entity is required to perform the related-party tiebreaker test (i.e., the analysis of which party is most closely associated with a VIE), and Section 7.4.2.4 discusses how to perform that test.

In addition, in accordance with ASC 810-10-25-44B, a reporting entity in a single decision maker’s related-party group should generally consolidate a VIE if (1) the reporting entity is a related party to a single decision maker that does not, individually, have both characteristics of a controlling financial interest, (2) no other party in the single decision maker’s related-party group individually has both characteristics of a controlling financial interest in the VIE, (3) the single decision maker and its related parties under common control do not have both characteristics of a controlling financial interest, and (4) substantially all of the activities of the VIE either involve or are conducted on behalf of the reporting entity. See Section 7.4.2.5 for a discussion of the “substantially all” characteristic.

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3 Paragraph BC70 of ASU 2015-02 states, in part, that “if there are no entities under common control that have the characteristics of a primary beneficiary, but substantially all of the activities of the VIE either involve or are conducted on behalf of a single variable interest holder (excluding the decision maker) in the single decision maker’s related party group (and the related party group has the characteristics of the primary beneficiary), the single variable interest holder for whom substantially all of the VIE’s activities either involve or are conducted on its behalf is required to consolidate the VIE as the primary beneficiary” (emphasis added). As a result, a single decision maker must be part of the related-party group for a reporting entity to consolidate a VIE in accordance with ASC 810-10-25-44B.
The following flowchart illustrates when the related-party tiebreaker test is required and when the “substantially all” characteristic is met:

Does a reporting entity individually have power and economics? (See Sections 7.2 and 7.3.)

- Yes: Reporting entity consolidates the VIE.
- No:

  Is power shared in a related-party group, and does the related-party group have economics? (See Section 7.4.2.2.)

    - Yes: Perform the related-party tiebreaker test (ASC 810-10-25-44) — party most closely associated with the VIE consolidates. (See Section 7.4.2.4.)
    - No:

      Is there a single decision maker?

        - Yes: Parent will consolidate; sister companies also need to apply related-party tiebreaker tests. (ASC 810-10-25-44) (See Section 7.4.2.4.)
        - No:

          Does a single decision maker have power, and does the related-party group under common control collectively have economics? (See Section 7.4.2.3.)

            - Yes: The related party to whom “substantially all” of the activities relate consolidates. (ASC 810-10-25-44B) (See Section 7.4.2.5.)
            - No:

              Does the related-party group have power and economics, and do substantially all the activities relate to one related party? (See Section 7.4.2.6.)

                - Yes: No one consolidates.
                - No: No one consolidates.
7.4.2.1 Situations in Which the Related-Party Tiebreaker Test Is Required

Identifying situations in which the related-party tiebreaker test is required is crucial to the consolidation analysis since as a result of the test, one of the entities in the related-party group will always consolidate the VIE. Before the amendments in ASU 2015-02, the related-party tiebreaker test was always required when an individual reporting entity did not have both characteristics of a controlling financial interest but the related-party group collectively did. ASU 2015-02 significantly changed when the related-party tiebreaker test is performed. A reporting entity now performs the test when either of the following applies:

- Power is “shared” within a related-party group and the related-party group meets both characteristics of a controlling financial interest. See Section 7.2.7.1 for further discussion of determining whether power is shared.

- A single decision maker has met the power criterion but not the economics criterion, and the aggregation of entities under common control with the single decision maker have met the economics criterion (see Section 7.4.2.3). See Section 8.2.2 for further discussion of related parties under common control.

7.4.2.2 Shared Power Within a Related-Party Group

ASC 810-10-25-38D states that power “is shared if two or more unrelated parties together have the power to direct the activities of a VIE that most significantly impact the VIE's economic performance and if decisions about those activities require the consent of each of the parties sharing power.” Two important points can be inferred from this description: (1) power is only considered shared when all of the activities that most significantly affect the VIE's economic performance require the consent of the parties sharing power and (2) two or more related parties cannot conclude that neither party should consolidate a VIE because they share power (i.e., the entity's governance requires that the related parties always have to act in concert with each other to make all significant decisions). Example 7-21 illustrates this concept by highlighting that the related-party group would not be required to perform the tiebreaker test if any party in the related-party group “could” vote together with another related party (without having to obtain the consent of all the related parties) because power is not considered shared. This also applies when the related parties are under common control; however, the substance of the power should be determined. See Section 7.2.8 for further discussion of the substance of power in common-control groups.

If the related-party group shares power and together meets the economics criterion, the party most closely associated with the VIE, as determined by performing the related-party tiebreaker test, will be the primary beneficiary.
Example 7-20

Two related parties, A and B, form a joint venture, Entity Z, that is a VIE. All decisions that most significantly affect Z require the consent of both A and B (i.e., the two parties are not responsible for different activities and do not have unilateral discretion for a portion of an activity).

Power can be shared only among multiple unrelated parties; two or more related parties cannot conclude that power is shared. Since the two venturers in this example are related parties, power cannot be considered shared between them even though they are required to consent to any decisions that are made. Thus, they will need to perform the analysis in ASC 810-10-25-44 (the related-party tiebreaker test) to determine which of them is most closely associated with the VIE and must therefore consolidate the VIE. If A and B were unrelated, neither entity would consolidate the VIE.

Example 7-21

Three related parties (A, B, and C) not under common control form Entity X (a VIE) and hold 25 percent, 35 percent, and 40 percent, respectively, of the entity's voting interests. Decisions about the activities that most significantly affect the VIE's economic performance require a simple majority vote of the voting interests. Consequently, two of the three parties must agree on all of the decisions that most significantly affect the VIE's economic performance. In this example, even though the related-party group holds 100 percent of the voting rights and economics, because X's corporate governance does not require the consent of all the parties, power is not considered shared. Therefore, performance of the related-party tiebreaker test is not required, and no party will consolidate X.

7.4.2.3 Single Decision Maker and Related Parties Under Common Control

If a single decision maker has met the power criterion but not the economics criterion, and the entities under common control with the single decision maker, in the aggregate, have met the economics criterion, the related-party tiebreaker test must be performed by the parties in the related-party group. In this situation, the purpose of the test would be to determine whether the decision maker or a related party under common control of the decision maker is required to consolidate the VIE. This is a significant change from a reporting entity's requirements before the adoption of ASU 2015-02, under which the related-party tiebreaker test was required any time a related-party group collectively could exert power over the most significant activities of a VIE and the related-party group met the economics criterion.

Since ASU 2015-02 became effective, two developments have occurred. First, the FASB issued ASU 2016-17, which amended the requirement to consider interests held through related parties under common control as if they were held directly by the decision maker in the primary-beneficiary analysis (see Section 7.3.5.1).
The ASU requires a decision maker to determine the primary beneficiary by considering these interests proportionately in a manner similar to its consideration of indirect interests held through related parties that are not under common control. As a result, there are more situations under ASU 2016-17 that require performance of the related-party tiebreaker test than there were under ASU 2015-02. Since ASU 2016-17 only changes the guidance in ASC 810-10-25-42, it affects the decision maker’s consideration of indirect interests held through related parties under common control only in the primary-beneficiary assessment (i.e., not in the determination of whether the decision maker has a variable interest).

Second, as discussed in Section 4.4.2.3.2, the FASB issued ASU 2018-17, which amended ASC 810-10-55-37D so that indirect interests held by related parties under common control are also only considered on a proportionate basis in the variable interest analysis. Therefore, a decision maker is less likely to be required to apply the VIE model under ASU 2018-17, because fewer fee arrangements would qualify as variable interests.

In addition, we have become aware of diversity in practice related to when a decision maker with contractual power does not have a variable interest but a related party under common control meets the economics criterion. Although it is clear that the parent should generally consolidate the VIE when parties under common control collectively meet both the power and economics criteria, differing views have emerged regarding when, if ever, one of the subsidiaries should consolidate the legal entity in its stand-alone financial statements.

We believe that (1) the decision maker should never be subject to consolidation if it does not have a variable interest (as clarified in an SEC speech — see Section 4.4.2.3.2 — which indicated that a decision maker that determines that its fee is not a variable interest should not be subject to potential consolidation as a result of the performance of the related-party tiebreaker test) and (2) the parent should generally consolidate. However, we do not believe that ASC 810 specifies clearly how a related party under common control with the decision maker (i.e., the non-decision maker) should determine whether it should consolidate in its stand-alone financial statements. Therefore, in the absence of additional clarification from the FASB or SEC staff, we believe that the following views could be appropriate, depending on the reporting entity’s facts and circumstances:

- **View A** — The related-party tiebreaker test should never be performed. In addition, in a manner consistent with the SEC staff speech discussed above, the decision maker should never consolidate since it does not have a variable interest through its fee arrangement. However, if substantially all the activities are on behalf of one of the related parties under common control (other than the decision maker), that party should consolidate in accordance with ASC 810-10-25-44B (see Section 7.4.2.5).

- **View B** — The related-party tiebreaker test should be performed to determine which related party under common control is most closely associated with the VIE. However, if the single decision maker is deemed to be the party most closely associated with the VIE, it would not consolidate in its stand-alone financial statements since doing so would be contrary to the guidance in the SEC speech discussed above, which indicates that a decision maker should not consolidate unless it holds a variable interest in the VIE.

In general, a reporting entity should apply its view consistently as an accounting policy election.
Example 7-22

Entity X and Entity Y are under common control but do not have ownership interests in each other. Entity X is the general partner (decision maker) for Partnership Z but does not own any of the limited partnership interests. Entity Y owns 51 percent of Z’s limited partner interests. The partnership is considered a VIE.

When X and Y each consider only their own respective interests, neither party individually would have both of the characteristics of a controlling financial interest. Entity X would conclude that it does not have a variable interest on its own (and has therefore not satisfied the power criterion) unless (1) the fee arrangement did not meet the commensurate and at-market conditions or (2) Z was designed to circumvent consolidation in the stand-alone financial statement of X or Y. In addition, Y would conclude that it meets the economics criterion but not the power criterion.

Under View A above, because X’s fee arrangement is not considered a variable interest, the related-party tiebreaker test would not need to be performed. Further, unless substantially all the activities are conducted on behalf of Y, neither X nor Y would be required to consolidate Z in its stand-alone financial statements. However, Parent would be required to consolidate Z in its consolidated financial statements because it has met both the power criterion (indirectly through X) and economics criterion (indirectly through Y).

Under View B above, the related-party tiebreaker test would be performed in the assessment of whether Y is the party most closely associated with Z. If Y concludes that X is the party most closely associated with Z, neither X nor Y would be required to consolidate Z in its stand-alone financial statements. However, Parent would be required to consolidate Z in its consolidated financial statements because it has satisfied both the power criterion (indirectly through X) and the economics criterion (indirectly through Y).

7.4.2.4 Performance of the Related-Party Tiebreaker Test

If the reporting entity is required to perform the related-party tiebreaker test, the party identified as most closely associated with the VIE will be the primary beneficiary. A reporting entity must consider all facts and circumstances associated with a VIE in making this determination. No single factor is determinative, and a reporting entity must use significant judgment.

ASC 810-10-25-44 lists four factors for a reporting entity to consider in making the determination. The reporting entity should evaluate (1) each factor individually to identify the extent to which one or more factors point toward a particular party and (2) the factors as a whole to determine which party is most closely associated with the VIE. For any given set of facts and circumstances, the relative weighting of each factor will most likely differ. However, it is important to recognize that the reporting entity’s overall objective is to determine which related party “is most closely associated with the VIE” as a whole; therefore, a comprehensive assessment of the relationship and significance of the activities of the VIE (ASC 810-10-25-44(b)) and the overall design of the VIE (ASC 810-10-25-44(d)) to each of the related parties (not just with respect to the reporting entity making the assessment) is paramount to the reporting entity’s exercise of judgment under ASC 810-10-25-44.
The four factors in ASC 810-10-25-44 are outlined below.

| Table 7-1 — Factors to Consider When Performing the Related-Party Tiebreaker Test |
|---------------------------------|-----------------------------------------------|
| Factor                          | Comments                                                                                     |
| ASC 810-10-25-44(a): “The existence of a principal-agency relationship between parties within the related party group.” | The existence of a principal-agency relationship typically indicates that the principal is most closely associated with a VIE. In assessing the relationship between related parties, the reporting entity should consider (1) whether a de facto agency relationship, as described in ASC 810-10-25-43, exists (this would result in a presumption that there is a principal-agency relationship) and (2) the guidance in ASC 470-50 and ASC 606-10-55-36 through 55-38 to determine whether, by analogy, a principal-agency relationship exists. |
| ASC 810-10-25-44(b): “The relationship and significance of the activities of the VIE to the various parties within the related party group.” | The analysis should take into account all of the significant activities conducted by the VIE, the extent to which one or both parties have an active role in conducting those activities, and the relative importance of the activities of the VIE to each party. In assessing the importance of the VIE’s activities to each party, the reporting entity should consider factors such as supply arrangements, purchase arrangements, and other material contracts. |
| ASC 810-10-25-44(c): “A party’s exposure to the variability associated with the anticipated economic performance of the VIE.” | It is generally possible to determine qualitatively whether one of the parties in a related-party group has greater exposure to the variability (positive and negative) associated with the VIE’s anticipated economic performance. |
| ASC 810-10-25-44(d): “The design of the VIE.” | It is important for the reporting entity to contemplate the design of the VIE, including the nature and reasoning behind the formation of the VIE at inception or as of the latest reconsideration date. The reporting entity should consider factors such as the business or economic purpose of the VIE, the role played by each of the parties in the design or redesign of the VIE, the level of ongoing involvement in the VIE’s financial and operating activities and decision making, and the VIE’s capital structure and levels of financial support. |

At the 2004 AICPA Conference on Current SEC and PCAOB Developments, an SEC staff member, Associate Chief Accountant Jane Poulin, stated:

It is important to read the words in paragraph 17 [codified as ASC 810-10-25-44] plainly. Paragraph 17 requires an overall assessment of which party is the most closely associated with the entity. When considering questions under paragraph 17, the staff considers all the factors in paragraph 17 and any other factors that may be relevant in making this overall assessment. We do not view paragraph 17 to be a matter of checking the boxes for the four factors listed and adding up who has the most boxes checked. Instead we look at all relevant factors in their entirety considering the facts and circumstances involved. We have also been asked whether any of the factors in paragraph 17 carry more weight than any others or whether any of the factors in paragraph 17 are determinative. There is no general answer to this question. Instead, the facts and circumstances of the situation should be considered to determine whether one factor or another is more important.
Example 7-23

Entity A and Entity B are related parties under common control, and each made an equity investment and share power in VIE X. There are no other variable interest holders or arrangements between A or B and X. Entity A is exposed to the majority of the variability associated with X's anticipated economic performance.

Neither A nor B individually has the characteristics of a controlling financial interest under ASC 810-10-25-38A. However, through their aggregated variable interests, A and B, as a group, have those characteristics. Assume that in an analysis of the factors in ASC 810-10-25-44(a), (b), and (d), it is not possible to determine which reporting entity is most closely associated with X because there is no apparent principal-agency relationship, the activities of X have roughly equal significance to both A and B, and both parties were equally involved in the design of X.

Given the nature of the transaction, it would be appropriate to weight ASC 810-10-25-44(c) (i.e., a party's exposure to variability associated with X's anticipated economic performance) more heavily because no other factor in ASC 810-10-25-44 points toward a particular party. Because A absorbs a majority of the variability associated with X's anticipated economic performance, it may be reasonable to conclude that A is the primary beneficiary of X.

Note that ASC 810-10-25-44(c) would not be weighted more heavily when one party controls some or all parties in the related-party group since that controlling party has the ability to dictate exposure to the variability associated with the VIE's anticipated economic performance to the controlled parties.

Example 7-24

Entity A and Entity B are related parties not under common control. They each made equity investments of $40 and $60, respectively, and share power in VIE X. There are no other variable interest holders. At inception, A entered into a supply agreement with X to purchase 100 percent of the output of X at prices initially identified as, and continually adjusted to, fair value. There are no other arrangements between A and B and X. Entity A is exposed to slightly more of the variability associated with X's anticipated economic performance than is B.

Neither A nor B individually has the characteristics of a controlling financial interest under ASC 810-10-25-38A. However, the aggregate variable interests of A and B, as a group, have those characteristics. In this example, A entered into a contractual arrangement with X to purchase 100 percent of the output of X at prices initially identified as, and continually adjusted to, fair value. The contractual arrangement would be an important consideration in A's evaluation of the factors associated with the activities (ASC 810-10-25-44(b)) and design of the entity (ASC 810-10-25-44(d)) and, individually, those factors may point toward A as the primary beneficiary. Entity A also has slightly greater exposure to the variability associated with X's anticipated economic performance.

Although A must also assess B under ASC 810-10-25-44, it may be reasonable to conclude that A should be considered the primary beneficiary on the basis of an evaluation of all the relevant factors, which seem to suggest that A is most closely associated with X.

7.4.2.4.1 Impact of Fees Paid to a Decision Maker or Service Provider in the Related-Party Tiebreaker Test

In the evaluation of whether a reporting entity should consolidate a VIE, fees paid to the reporting entity are excluded from the assessment under ASC 810-10-25-38A(b) if they meet the conditions in ASC 810-10-25-38H (see Section 7.3.4). In addition, fees that met the conditions in ASC 810-10-25-38H would not be considered in the determination of whether the related-party group collectively has the characteristics of a controlling financial interest. Notwithstanding that exclusion for those purposes, if the related-party tiebreaker test must be performed, the fees should be considered in the assessment of which party in the related-party group is most closely associated with the VIE.
Example 7-25

Company A and Company B, which are considered related parties, form a joint venture, Entity C, which was designed to invest in real estate assets for current income and capital appreciation. Entity C is a VIE. Both A and B own 50 percent of the equity interests of C. In addition, A serves as the managing member and property manager of C, and it receives a fee in return for the services provided. The fee arrangement meets the definition of a variable interest in ASC 810-10-55-37 because A has a significant variable interest in C through its equity ownership. Although A is the designated managing member and property manager of C, the decisions about the activities that most significantly affect the economic performance of C require the consent of both A and B; thus, power over the significant activities of C would be considered shared in the absence of a related-party relationship between A and B.

However, A and B cannot be considered to have shared power because they are related parties. As a result, A and B must perform an evaluation to determine which party within the related-party group is most closely associated with C and must therefore consolidate C. That evaluation should take into consideration all the variable interests owned by A and B, including the fee arrangement of A.

Example 7-26

Company X is the general partner of a limited partnership that was designed to invest in equity and debt securities issued by emerging growth companies. Two entities that are under common control with X own 15 percent of the limited partnership interests, and the remaining 85 percent is owned by unrelated limited partners. The partnership is a VIE.

As general partner, X has the power to direct the activities that significantly affect the economic performance of the partnership (i.e., purchasing and selling investments). In return for its services, X receives a fixed management fee that does not meet the economics criterion (and the fee arrangement is not commensurate or at market). Company X does not have any other interests in the partnership or any interests in its related parties under common control.

Company X's fee arrangement must be evaluated under ASC 810-10-55-37 and is considered a variable interest because the fee arrangement is not commensurate or at market (i.e., does not satisfy ASC 810-10-55-37(a) or 55-37(d)).

While the fee arrangement is considered a variable interest, it does not meet the economics criterion, and none of the limited partnership interests held by X's related parties under common control would be considered indirectly owned by X, and X does not have any other interests in the partnership. Therefore, X does not individually have a controlling financial interest in the partnership or any interests in its related parties under common control.

However, because the related parties under common control, as a group, meet the power criterion and the economics criterion, they must determine which party in the related-party group is most closely associated with the partnership and must therefore consolidate the partnership. In performing the evaluation, the related parties should consider the design and purpose of the limited partnership, including the fees earned by X.

7.4.2.5 The “Substantially All” Characteristic

A reporting entity in a single decision maker’s related-party group4 is required to consolidate a VIE if (1) the reporting entity is a party that is related to a single decision maker that does not, individually, have both of the characteristics of a controlling financial interest, (2) no other party in the related-party group individually has both characteristics of a controlling financing interest in the VIE, (3) the single decision maker and its related parties under common control do not have both characteristics of a controlling financial interest, and (4) substantially all of the activities of the VIE either involve or are conducted on behalf of the reporting entity. The FASB was concerned that without this provision, a reporting entity would not consolidate an entity that was designed to act on its behalf. The phrase “substantially all” is consistent with the assessments in ASC 810-10-15-14(c)(2) for determining whether

4 See footnote 3.
an entity is a VIE and whether a reporting entity can apply the business scope exception (see Sections 5.4.2 and 3.4.4.7 for detailed discussions of this phrase).

Example 7-27

An investment manager establishes a fund on behalf of Investor B. The investment manager owns 5 percent of the equity in the fund, and B owns the remaining interests. The investment manager cannot be removed as the decision maker of the fund, and the investment manager cannot sell or liquidate its investment without the consent of B. The fund is considered a VIE. In addition, as a result of B's one-way transfer restriction, the investment manager and B are considered related parties (de facto agents).

When the investment manager and B each consider only their own respective interests, neither party would be required to consolidate the fund in its stand-alone financial statements. However, B would be required to consolidate the fund because (1) the related-party group possesses the characteristics of a primary beneficiary and (2) given the nature and size of B's interests in the fund, substantially all of the VIE's activities are conducted on behalf of B.

Note that the FASB specifically excludes investors in qualified affordable housing projects (e.g., low-income housing tax credit (LIHTC) partnership structures) that are within the scope of ASU 2014-01 from this consolidation requirement. The Board was concerned that as a result of the related-party provision, a single limited partner investor that held more than 90 percent of the limited partner interests in an LIHTC partnership may have otherwise had to consolidate if the general partner was a related party or de facto agent of the investor. Notwithstanding this exception, we note that the determination of “substantially all" is not based solely on economic interests but rather also on the “activities" of the VIE. Therefore, we do not believe that this exception should imply that holding more than 90 percent of the economic interests in a VIE equates to involvement with substantially all of the VIE's activities. Rather, the reporting entity should consider all facts and circumstances, including the activities of the partnership and active involvement by the general partner in operating the partnership. See Section E.4 for more information about investments in qualified affordable housing projects.
8.1 Introduction

The effect of interests held by related parties requires careful consideration when applying the VIE consolidation requirements since such interests may be used to achieve a desired consolidation conclusion for VIEs. The VIE model includes specific considerations regarding related parties, including identification of de facto agents (additional entities that are considered related parties in a VIE consolidation analysis) and how interests held by the reporting entity's related parties affect the consolidation analysis. The VIE model further distinguishes between the treatment of interests held by related parties under common control, related parties that are not under common control, and de facto agents.

Related-party considerations are pervasive in the consolidation analysis, and they are applied differently in each of its steps. Accordingly, related-party implications are discussed throughout this Roadmap. In this chapter, the identification of related parties and de facto agents is addressed in Section 8.2 below, and a high-level summary of how related parties should be considered in each step of the consolidation analysis is presented in Section 8.3.

8.2 Identifying Related Parties and De Facto Agents

<table>
<thead>
<tr>
<th>ASC 810-10</th>
</tr>
</thead>
<tbody>
<tr>
<td>25-43 For purposes of applying the guidance in the Variable Interest Entities Subsections, unless otherwise specified, the term related parties includes those parties identified in Topic 850 and certain other parties that are acting as de facto agents or de facto principals of the variable interest holder. All of the following are considered to be de facto agents of a reporting entity:</td>
</tr>
<tr>
<td>a. A party that cannot finance its operations without subordinated financial support from the reporting entity, for example, another VIE of which the reporting entity is the primary beneficiary</td>
</tr>
<tr>
<td>b. A party that received its interests as a contribution or a loan from the reporting entity</td>
</tr>
<tr>
<td>c. An officer, employee, or member of the governing board of the reporting entity</td>
</tr>
<tr>
<td>d. A party that has an agreement that it cannot sell, transfer, or encumber its interests in the VIE without the prior approval of the reporting entity. The right of prior approval creates a de facto agency relationship only if that right could constrain the other party's ability to manage the economic risks or realize the economic rewards from its interests in a VIE through the sale, transfer, or encumbrance of those interests. However, a de facto agency relationship does not exist if both the reporting entity and the party have right of prior approval and the rights are based on mutually agreed terms by willing, independent parties.</td>
</tr>
<tr>
<td>1. Subparagraph superseded by Accounting Standards Update No. 2009-17</td>
</tr>
<tr>
<td>2. Subparagraph superseded by Accounting Standards Update No. 2009-17</td>
</tr>
<tr>
<td>e. A party that has a close business relationship like the relationship between a professional service provider and one of its significant clients.</td>
</tr>
</tbody>
</table>
ASC 850-10-20 defines the term “related parties” as follows:

Related parties include:

a. Affiliates of the entity
b. Entities for which investments in their equity securities would be required, absent the election of the fair value option under the Fair Value Option Subsection of Section 825-10-15, to be accounted for by the equity method by the investing entity
c. Trusts for the benefit of employees, such as pension and profit-sharing trusts that are managed by or under the trusteeship of management
d. Principal owners of the entity and members of their immediate families
e. Management of the entity and members of their immediate families
f. Other parties with which the entity may deal if one party controls or can significantly influence the management or operating policies of the other to an extent that one of the transacting parties might be prevented from fully pursuing its own separate interests
g. Other parties that can significantly influence the management or operating policies of the transacting parties or that have an ownership interest in one of the transacting parties and can significantly influence the other to an extent that one or more of the transacting parties might be prevented from fully pursuing its own separate interests.

8.2.1 Identifying Related Parties

The VIE subsections of ASC 810-10 define related parties as those identified in ASC 850 and certain other parties that are acting in a de facto agency capacity with the variable interest holder. However, identifying which parties meet the definition of a related party of the reporting entity under ASC 850 will often require judgment, especially in complex structures.

**Example 8-1**

Subsidiary A and Equity Method Investee (EMI) 1 form a joint venture that is a VIE. When identifying its related parties as part of its consolidation analysis, A would consider EMI 1 a related party. Specifically, in accordance with ASC 810-10-25-1, Investor has a controlling financial interest in A; therefore, A is part of the consolidated group. Correspondingly, in accordance with ASC 323-10-15-6, this same consolidated group (through the interests held by Investor) has significant influence over the operating and financial policies of EMI 1. Accordingly, the consolidated group can exert significant influence over EMI 1 to the extent that in a transaction between A and EMI 1, Investor (or the consolidated group) might prevent EMI 1 from fully pursuing its own separate interests and meets the definition of a related party in ASC 850. Therefore, A and EMI 1 are considered related parties in the assessment of which party should consolidate the joint venture.
Equity Method Investees (EMIs) 1 and 2 form a joint venture that is a VIE. The joint venture was created with at-market terms, and there are no other transactions between EMI 1 and EMI 2. Investor has significant influence over the operating and financial policies of both EMIs 1 and 2. However, assume that both EMI 1 and EMI 2 have a typical corporate governance structure in which Investor is not able to unilaterally make decisions for the investees or influence the decision to form the VIE in a manner that prevents each party from fully pursuing its own interests. Therefore, unless there are other arrangements between EMIs 1 and 2, the related-party relationship is between Investor and the two EMIs, and not between EMI 1 and EMI 2. Accordingly, on the basis of these facts and circumstances, EMI 1 and EMI 2 would not be related parties.

8.2.2 Related Parties Under Common Control

In certain parts of the VIE consolidation analysis, the effects of interests held by the reporting entity’s related parties will depend on whether the related party is “under common control.” Therefore, the determination of whether a related party is under common control could significantly affect the consolidation conclusion.

The Codification does not specifically define common control. However, in paragraph BC69 of ASU 2015-02, the FASB explains that under the VIE model, and specifically in the application of ASC 810-10-25-42, ASC 810-10-25-44A, and ASC 810-10-55-37D, entities under common control would include “subsidiaries controlled (directly or indirectly) by a common parent, or a subsidiary and its parent.”
Company R has a wholly owned, consolidated asset management subsidiary, Subsidiary A. Subsidiary A is the 1 percent general partner of the Fund. Subsidiary A’s general partner interest gives A decision-making rights over the Fund, and in exchange for performing its services, A is entitled to receive a base management fee and a performance-based fee (or carried interest) equal to 20 percent of all returns in excess of a specified threshold. These fees are considered “commensurate” and “at market” (see Section 4.4.1). Company R also has a 1 percent general partner interest in Co-Investment Fund E. Company R has the power through its general partner interest to direct all the significant activities of E and cannot be removed without cause. However, R does not have an obligation to absorb losses of E or a right to receive benefits from E that could potentially be significant to E. Therefore, R does not consolidate E. Because R does not consolidate E, a parentsubsidiary relationship does not exist between R and E, and thus E and A are not considered related parties under common control.

The parent in a parentsubsidiary relationship does not need to be a separate legal entity. That is, an individual that possesses a controlling financial interest may be identified as a parent. The ASC master glossary defines “parent” as “an entity that has a controlling financial interest in one or more subsidiaries” (emphasis added).

On the basis of the above description of common control, common ownership does not represent common control. That is, in some instances, two or more reporting entities may have a high degree of common ownership, which would typically result in a conclusion that the reporting entities are not under common control.

Two unrelated individuals (that have not agreed to vote in concert) each own 50 percent of both Entity A and Entity B, but neither has a controlling financial interest in either A or B. In this case, A and B would be considered related parties with common ownership, but not under common control.
8.2.3 Identifying De Facto Agents

The VIE model expands the population of other entities whose interests are considered by the reporting entity in its VIE analysis to include interests of parties that are acting in a de facto agency relationship with the reporting entity. The FASB identified certain relationships that may indicate that one party (the “de facto agent”) may be acting on behalf of another (the “de facto principal”). However, regardless of whether a reporting entity is identified as a de facto agent or a de facto principal, the reporting entity must consider the impact of the related-party relationship throughout the VIE model.

The following sections discuss the de facto agents identified by the FASB:

- “A party that cannot finance its operations without subordinated financial support from the reporting entity, for example, another VIE of which the reporting entity is the primary beneficiary” — Section 8.2.3.1 below.
- “A party that received its interests as a contribution or a loan from the reporting entity” — Section 8.2.3.2 below.
- “An officer, employee, or member of the governing board of the reporting entity” — Section 8.2.3.3.
- “A party that has an agreement that it cannot sell, transfer, or encumber its interests in the VIE without the prior approval of the reporting entity [that prevents the other party from managing the economics of its interest]. However, a de facto agency relationship does not exist if both the reporting entity and the party have [rights] of prior approval and the rights are based on mutually agreed terms by willing, independent parties” — Section 8.2.3.4.
- “A party that has a close business relationship like the relationship between a professional service provider and one of its significant clients” — Section 8.2.3.5.

8.2.3.1 Subordinated Financial Support Received From the Reporting Entity

A de facto agency relationship exists if the other party is financially dependent on the reporting entity or a legal entity consolidated by the reporting entity. Identifying such a de facto agency relationship is typically straightforward.

8.2.3.2 Interests Received as a Loan or Contribution

A de facto agency relationship is generally created when another party receives its interest in the VIE as a contribution or a loan from the reporting entity, even if the loan or contribution only covers a portion of the interest. While this de facto agency is intended to prevent a reporting entity from avoiding consolidation of a VIE by structuring transactions so that another party holds a variable interest in the VIE that the reporting entity is exposed to through the loan, it is not simply an anti-abuse provision. That is, it is on the FASB’s list of de facto agencies; thus, if the de facto agency criteria are met, the parties are generally considered related.

We have historically viewed fixed-price put options to be the economic equivalent of a loan (see Table 5-1). That view was premised on the fact that a nonrecourse loan and a purchased put option give an investor similar down-side protections. While we appreciate that some may continue to hold that view, our perspective on the issue has evolved. Although purchased put options and nonrecourse loans provide similar down-side protections, substantive differences between them exist related to form and substance. Notably, a loan provides capital to the investor to make an investment, whereas the purchased put option does not provide any capital to the option’s holder up front. That is, a lender provides capital to the borrower when the lender extends a loan; an option’s writer does not extend financing to the buyer of the put option up front. On the basis of that distinction, we have updated
our interpretation related to this matter and believe a purchased put option should be considered analogous to a loan guarantee. The down-side protection provided by the put option is economically equivalent to a guarantee of the financing deployed to invest in the entity.

However, not all interests received as a loan will result in a de facto agency relationship. In very limited situations, two reporting entities need not consider themselves related parties when one of the reporting entities has received its interest as a loan from the other reporting entity. This exception would be limited to scenarios in which the party providing the loan to another party involved with the potential VIE is in the business of extending credit in the normal course of its business. In addition to this requirement, the following factors (not all-inclusive) may indicate that the existence of a loan between two variable interest holders does not create a related-party relationship under ASC 810-10-25-43:

- The creditor does not control and is not able to significantly influence the debtor.
- The debtor receives the full benefits and obligations associated with its financed interest. The debtor's rights associated with its interest are not affected by the fact that the financing was provided by another variable interest holder.
- The debtor was not required to obtain its financing from the creditor. That is, the debtor has the right to obtain its interest in whatever way it chooses (i.e., paying cash or financing the interest with any party it chooses).
- The loan is originated in the normal course of business as an arm's-length commercial transaction. A reporting entity must consider whether the loan was provided at market rates in a manner similar to its consideration of rates provided for comparable transactions.
- The lender has full recourse to the debtor's assets, the debtor's ability to repay the loan does not depend on the performance of the interest lent, and the creditor is able to pursue any remedy available by law.
- The creditor has the right to sell, pledge, or hold the loan.
- The debtor has the right to sell or hold the financed interest. Restrictions placed on the financed interest should be considered in a manner similar to the analysis required by ASC 810-10-25-43(d).

Example 8-5

Company A and Company B establish VIE X, each contributing 50 percent of the equity. Company B has a commercial lending subsidiary that provides credit for various business transactions in the normal course of business. Company A, to finance its equity contribution to VIE X, was approved to borrow an equal amount of funds from B's lending subsidiary. The loan was originated in a manner similar to all other commercial loans of B, A was not required to obtain the funds from B, B has full recourse to all of A's assets, and there are no restrictions in the lending arrangement on A's ability to sell or hold its interest in VIE X. On the basis of these facts and circumstances, although A happened to obtain the funds necessary for its investment in VIE X from B's lending subsidiary, the parties may conclude that a de facto agency relationship does not exist.

Example 8-6

Assume the same facts as Example 8-5, except that B does not make commercial loans in the normal course of its business. Instead, in the formation of VIE X, A and B agreed that A would borrow funds necessary to make its equity investment from B. On the basis of these facts and circumstances (primarily, that B is not in the business of making similar loans), a de facto agency relationship exists. Said differently, the lending arrangement was a primary part of the design and purpose of the formation of X.
8.2.3.3 Officer, Employee, or Member of the Governing Board of the Reporting Entity
A de facto agency relationship will also exist if the other party is an officer, employee, or member of the governing board of the reporting entity. Identifying this de facto agency relationship is typically straightforward.

8.2.3.4 Transfer Restrictions
A de facto agency relationship can be created contractually on the basis of the terms of an arrangement. For example, ASC 810-10-25-43(d) states that a de facto agency relationship is present when a party has entered into an agreement under which it “cannot sell, transfer, or encumber its interests in the VIE without the prior approval of the reporting entity.” However, a de facto agency relationship exists only if having to obtain such approval constrains the other party’s ability to manage substantially all of its economic interest in the VIE. Whether restricting sales or transfers constrains another party depends on the facts and circumstances. Factors to consider in determining whether a restriction constitutes a constraint may include, but are not limited to, the following:

- Generally, in the determination of whether a restriction on sales or transfers constrains another party, a phrase in a contractual agreement such as “without prior approval, which cannot be unreasonably withheld” indicates that a variable interest holder is not constrained from managing the economic risks or realizing the economic rewards of its interest. In other circumstances, a phrase such as this may not be an indicator that the variable interest holder is not constrained. Conversely, a de facto agency relationship is presumed if such language is absent from a contractual agreement or if the agreement only cites narrow specific circumstances that would not typically be encountered under which approval cannot be unreasonably withheld. We believe that this interpretation specifically addresses sales and transfers and should generally not be applied to the evaluation of whether the rights held by a noncontrolling shareholder are substantive participating rights. For a discussion of the effect of such contractual language on the evaluation of whether a noncontrolling interest holder has substantive participating rights, see Section D.2.3.1.
- If a party has the ability to realize the economic benefits of its interest by selling that interest without the reporting entity’s prior approval, the party would not be constrained even if the reporting entity’s approval is required for all other transfers or encumbrances of that interest.
- If the right of prior approval is designed solely to prevent transfer of the interest to a competitor or to a less creditworthy, or otherwise less qualified, holder, and such parties are not the only potential purchasers of that interest, the party would not be constrained.
- A party is constrained if it cannot sell, transfer, or encumber its interest but can manage the risk of owning the interest by hedging that risk.
- A right of first refusal (a requirement that gives the holder of the right the ability to match an offer) or a right of first offer (a requirement that the interest holder must first offer to sell its interest to the holder of the right prior to selling it to a third party) generally does not create a de facto agency relationship. This is because these rights would not constrain the variable interest holder from managing its economic interest in the entity.
- A restriction that precludes a variable interest holder from selling, transferring, or pledging its interest for a period of time would create a de facto agent relationship during that period. However, once the restriction expires, the party would no longer be considered a de facto agent, and the reporting entity would need to reevaluate its consolidation conclusion.
In addition, as indicated in ASC 810-10-25-43(d), “a de facto agency relationship does not exist if both the reporting entity and the party have right of prior approval and the rights are based on mutually agreed terms by willing, independent parties.” For example, in a typical joint venture structure, transfer restrictions are often imposed on all the venturers to maintain the structure of the joint venture. Since these transfer restrictions “are based on mutually agreed terms by willing, independent parties,” the venturers may not be de facto agents.

**Example 8-7**

Company X has a $1 million interest in VIE 1. Company Y, another interest holder in VIE 1, must approve all sales and transfers of X’s interest. Company X does not have a similar right of prior approval for sales and transfers of Y’s interest in VIE 1. Company X otherwise may encumber its interest in VIE 1 without the approval of Y; however, financial institutions will only lend X up to $300,000 if X uses its $1 million interest as collateral. Thus, X is able to manage only a portion of its risk by encumbering its interest. Because X cannot realize, by encumbrance, all or most of the cash inflows that are the primary economic benefits of its interest, X is constrained and is deemed to have a de facto agency relationship with Y.

**Example 8-8**

Assume the same facts as in Example 8-7. In addition, X enters into a total return swap with an unrelated third party, Banker 1, to economically hedge its variable interest. Under the total return swap, X will receive cash equal to substantially all of the benefits encompassed in its variable interest during the term of the swap. Under the terms of the swap, X is not acting as an agent for Banker 1. Although X has managed its risk of ownership in VIE 1, X is constrained (because a total return swap is not a sale, transfer, or encumbrance) and is deemed to have a de facto agency relationship with Y.

**Example 8-9**

Assume the same facts as in Example 8-7, except that VIE 1 is a franchise (that does not meet the business scope exception in ASC 810-10-15-17(d)), and the franchise agreement stipulates that the franchisor must approve any prospective purchases of the franchisee’s interest that are to competitors, less creditworthy purchasers, or purchasers that do not intend to maintain the franchise at the existing level of quality. There are several other potential purchasers that would qualify. The franchisee is not considered constrained under ASC 810-10-25-43(d) because it can still manage its economic interest in VIE 1 through sale and transfer (i.e., the restriction is only on the sale to a nonqualified investor and there are other qualified investors who could purchase the interest).

**Example 8-10**

Two parties enter into a joint venture for 20 years. The entity does not meet the business scope exception in ASC 810-10-15-17(d) and is determined to be a VIE. The joint venture partners have entered into a five-year lock-up agreement whereby neither party is permitted to sell, transfer, or encumber its interest in the joint venture without the written consent of the other party. Since the two parties both have the right of prior approval, have mutually agreed on the prior approval terms, and are willing, independent parties, the two parties are not considered related parties (i.e., de facto agents) for the term of the lock-up period.

### 8.2.3.4.1 Effect of a Put Option on Analyzing Transfer Restrictions

In certain situations in which transfer restrictions are contractually in place, a de facto agency relationship may not be present if the restricted party has a separate put option that effectively allows that party to manage its economics through exercise of the put option. The existence of a fair value put option that is currently exercisable for 100 percent of the interest held and with no restrictions
may be sufficient to allow the reporting entity holding the put option to manage the economic risks or realize the economic rewards from its interests in a VIE. However, the reporting entity should evaluate all facts and circumstances to determine whether a put option would affect whether a de facto agency relationship exists. For example, fair value should be based on an independent valuation as of the exercise date rather than on a predetermined formula that is not updated to reflect current market conditions. Conversely, if the exercise price of the put option is fixed or at other than fair value, the de facto agency relationship cannot be overcome.

8.2.3.5 Close Business Relationship

A de facto agency relationship can also exist if the reporting entity has a close business relationship with another party. We understand that the intent of this guidance is to prevent potential structuring opportunities in which a reporting entity attempts to avoid consolidation by transferring its variable interests in a legal entity to its professional service providers. In certain situations, a reporting entity may contract with service providers and delegate power to those providers over certain activities to achieve off-balance-sheet accounting. In these cases, inclusion of these service providers as de facto agents would require the reporting entity to consider whether it should consolidate because of the combination of its direct power and economics as well as the power or economics granted to the service provider.

At the 2008 AICPA Conference on Current SEC and PCAOB Developments, an SEC staff member, Professional Accounting Fellow Robert Malhotra, discussed the close business relationship provision. Although his remarks refer specifically to FIN 46(R), the guidance on close business relationships has not changed as a result of Statement 167 and ASU 2015-02. His speech stated, in part:

In the context of paragraph 5(c) of FIN 46R, the staff has been asked whether certain close business associates may be considered related parties under Statement 57 or paragraph 16 of FIN 46R. In this context, the staff believes that close business associates may only be considered related parties if one party can control or can significantly influence the other party to an extent that one of the parties might be prevented from fully pursuing their own separate interest should that party choose to do so. That being the case, the mere past practice or future intent of close business associates to collaborate would be insufficient to conclude the parties are related. The staff believes that this is consistent with the definition of a related party included in Paragraph 24 of Statement 57. [Footnote omitted]

Therefore, reporting entities should carefully evaluate professional service providers as potential close business relationships to determine whether one party controls or significantly influences the other party such that one of the parties might be prevented from fully pursuing its own interest. Reporting entities should examine professional service providers, such as attorneys, investment bankers, and accountants, who help structure a transaction or entity to determine whether the purpose of the structuring was to avoid consolidation (i.e., the service provider is acting solely as an intermediary). Considerations in this analysis should include but not be limited to whether:

- The reporting entity does not appear to have a variable interest in the structured entity because the variable interest is held by the service provider.
- The service provider lacks other significant sources of income.
- The service provider is incentivized to make decisions that align with the reporting entity.
- The service provider was significantly involved in the formation and structuring of the legal entity.
- The cash flow streams result in “round tripping.”
8.3 Related-Party Considerations Under the VIE Model

As discussed throughout this Roadmap, interests held by a reporting entity's related parties or de facto agents could have a significant effect on the reporting entity's consolidation conclusions. Table 8-1 below summarizes, and provides references to expanded discussions about, the effect of related parties and de facto agents on the VIE analysis.

<table>
<thead>
<tr>
<th>Evaluation Under the Consolidation Analysis</th>
<th>Which Interests Held by Reporting Entity's Related Parties Should Be Considered?</th>
<th>Which Interests Held by Reporting Entity's De Facto Agents Should Be Considered?</th>
</tr>
</thead>
<tbody>
<tr>
<td>Applicability of “business scope exception” (see Section 8.3.1)</td>
<td>All</td>
<td>All, except for interest held by de facto agents because of “transfer restrictions”</td>
</tr>
<tr>
<td>Determining whether the reporting entity holds a variable interest for arrangements other than decision-maker or service-provider arrangements (see Section 8.3.2)</td>
<td>All</td>
<td>All</td>
</tr>
<tr>
<td>Determining whether a decision maker or service provider holds a variable interest (see Section 8.3.3)</td>
<td>Any indirect interest through the related party (except most employees and employee benefit plans) and interests held by related parties under common control(^1)</td>
<td>Any indirect interest through the de facto agent (other than employees)</td>
</tr>
<tr>
<td>Determining whether an entity is a VIE — analyzing kick-out and participating rights for a legal entity other than a limited partnership or similar entity (see Section 8.3.4)</td>
<td>All</td>
<td>All</td>
</tr>
<tr>
<td>Determining whether an entity is a VIE — analyzing kick-out rights and participating rights for a limited partnership or similar entity (see Section 8.3.5)</td>
<td>Entities under common control with the general partner or other parties acting on behalf of the general partner</td>
<td>Parties acting on behalf of the general partner</td>
</tr>
<tr>
<td>Determining whether an entity is a VIE — substantially all of the activities involve or are conducted on behalf of a reporting entity and its related parties (see Section 8.3.6)</td>
<td>All</td>
<td>All, except for interest held by de facto agents because of “transfer restrictions”</td>
</tr>
<tr>
<td>Identifying a VIE’s primary beneficiary (see Section 8.3.7)</td>
<td>All</td>
<td>All</td>
</tr>
</tbody>
</table>

\(^1\) In October 2018, the FASB issued ASU 2018-17, which requires all indirect interests held through related parties, regardless of whether they are under common control, to be considered proportionately in the determination of whether a service provider's fee represents a variable interest. See Section 4.4.2.3.2 for further information.
8.3.1 **Business Scope Exception**

The “business scope exception” exempts reporting entities from evaluating whether a legal entity that qualifies as a business under ASC 805 is a VIE unless one or more conditions apply (see Section 3.4.4). In evaluating whether an entity that is a business meets any of the conditions that would preclude it from qualifying for the business scope exception, the reporting entity must consider interests held by its related parties, including those held by de facto agents, other than de facto agency relationships created by transfer restrictions as described in Section 8.2.3.4. Under the business scope exception guidance in FIN 46(R), any transfer restriction resulted in the identification of a de facto agent. The FASB therefore decided to exclude transfer restriction de facto agents from the analysis of the business scope exception in FIN 46(R) because investors in joint ventures under joint control otherwise would have not been able to qualify for this exception. Although the definition of a de facto agent created by transfer restrictions has changed since issuance of FIN 46(R), this exclusion has not.

8.3.2 **Determining Whether the Reporting Entity Holds a Variable Interest for Arrangements Other Than Decision-Maker or Service-Provider Arrangements**

A reporting entity that does not hold a variable interest directly in a VIE should generally not consider variable interests held by its related parties as its own (other than decision-maker fees or service-provider fees as discussed in Section 8.3.3 below). However, it may not always be apparent whether a reporting entity holds a variable interest in a legal entity, because the reporting entity may not have a direct contractual interest in the VIE (i.e., the reporting entity may be implicitly or indirectly exposed to the VIE through its related party). A reporting entity should carefully scrutinize all arrangements (whether explicit or implicit) between related parties to determine whether an implicit variable interest exists when (1) the reporting entity's related parties have entered into transactions on behalf of the reporting entity and (2) the reporting entity otherwise would have consolidated the VIE if it was determined that the reporting entity had a direct or explicit variable interest in the VIE. (For more information about implicit variable interests, see Section 4.3.10.)

**Example 8-11**

Companies A and B formed a VIE with the issuance of an equity instrument to A and a debt instrument to B. Company C, a related party of A, provided a loan to A to purchase its interest, but C does not have an interest directly in the VIE and does not limit A's exposure to expected losses or expected residual returns. In preparing its financial statements, C generally does not have to consider whether it would need to consolidate the VIE because it does not hold a direct variable interest in that entity. However, C holds a variable interest in A as a result of its related-party loan, and it may need to consider whether A is a VIE. Further, regardless of whether A is considered a VIE, if the terms of the loan are such that A is acting as an agent for C (e.g., a nonrecourse participating loan for which C essentially is receiving all the risks and rewards of A's interest in the VIE), C may be deemed to have an implicit variable interest in the VIE.

8.3.3 **Determining Whether the Reporting Entity Holds a Variable Interest (Decision-Maker and Service-Provider Fees)**

As discussed in Section 4.4.2.3, a reporting entity that is a decision maker or service provider must, among other things, analyze other interests held by certain related parties and de facto agents. Understanding the impact that related parties and de facto agents have on this determination can be challenging because of the nature of items that are included in, or excluded from, the assessment. Table 8-2 summarizes how interests held by related parties should be considered in the assessment of a reporting entity's exposure to expected losses or expected residual returns through its other interests under ASC 810-10-55-37(c).
### Table 8-2 — Consideration of Interests Held by Related Parties

<table>
<thead>
<tr>
<th>Decision Maker’s Interests</th>
<th>Entities Under Common Control</th>
<th>Other Related Parties</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Always</strong> include the direct interests held by the decision maker in its evaluation.</td>
<td>Include the interests held by entities under common control (see Section 8.2.2 for definition of common control) in the decision maker’s evaluation at its full amount, only if the decision maker or service provider has a variable interest in the related party or the interest was provided to the related party under common control to circumvent the consolidation guidance (see Section 4.4.2.3.2 for a discussion of ASU 2018-17, which removes the requirement for consideration of the full amount when the reporting entity has an interest through a related party under common control).</td>
<td>Include the decision maker’s indirect interest through its related parties and de facto agents on a proportionate basis. That is, the decision maker is required to have a variable interest in the related party. The FASB specifically excluded employees and employee benefit plans of the decision maker unless the employee or employee benefit plan is being used to circumvent the VIE model (see Sections 4.4.2.3.5 and 4.4.2.3.6 for more information about the impact of employees and employee benefit plans).</td>
</tr>
</tbody>
</table>

### 8.3.4 Determining Whether a Legal Entity Is a VIE — Analyzing Kick-Out and Participating Rights for a Legal Entity Other Than a Limited Partnership or Similar Entity

In the evaluation of whether the equity group at risk has the power to direct the activities that most significantly affect the legal entity’s economic performance, ASC 810 distinguishes between entities that are limited partnerships (and similar entities) and all other entities. The FASB created this dual approach because the general partner of a limited partnership typically has the unilateral ability to direct a limited partnership’s most significant activities.

A legal entity other than a limited partnership is a VIE unless the equity group at risk (the equity investors) holds voting rights or similar rights that enable the group to direct the activities that most significantly affect the legal entity’s economic performance. In some situations, the right to direct these activities may be held by a party that is not considered part of the equity group; however, the equity group may have the ability to participate in these decisions or remove the decision maker.

In the evaluation of whether kick-out rights or participating rights held by the equity group at risk give the equity holders the power to direct the activities that most significantly affect the legal entity’s economic performance, these rights would only be considered if they can be exercised by a single equity holder, including the equity holder’s related parties and de facto agents. Rights held by multiple unrelated parties would be ignored. In addition, rights that give another party outside the equity investment at risk the ability to remove such power from the equity group would only be considered in the analysis if they can be exercised by a single interest holder, including the interest holder’s related parties and de facto agents. For example, if a single debt holder of a legal entity is able to participate in the most significant decisions of the entity, the legal entity would be considered a VIE. However, if two unrelated debt investors together held this right, the entity would not be a VIE.

See Section 5.3.1.1.3.4 for further discussion.
8.3.5 Determining Whether an Entity Is a VIE — Analyzing Kick-Out and Participating Rights for a Limited Partnership or Similar Entity

The evaluation of whether the equity group at risk has the power to direct the activities that most significantly affect the economic performance of a limited partnership (or similar entity) focuses on the rights of the limited partners. A limited partnership is a VIE unless (1) a simple majority or lower threshold of the limited partners with equity at risk can kick out the general partner or (2) the limited partners with equity at risk have substantive participating rights.

In the evaluation of kick-out rights held by the limited partners, any rights held by entities under common control of the general partner or other parties acting on behalf of the general partner are excluded from the evaluation. Accordingly, if a related party that is considered to be acting on behalf of the general partner is able to participate in the exercise of the kick-out rights, the limited partners may not meet the simple majority threshold, and the legal entity would therefore be a VIE. Note that this evaluation does not focus on related parties or de facto agents of the general partner but rather on those parties “acting on behalf of the general partner.” In the determination of whether participating rights are substantive, ASC 810-10-25-13(c) requires the consideration of related-party relationships as defined in ASC 850.

See Section 5.3.1.2.2 for further discussion.

8.3.6 Determining Whether an Entity Is a VIE — Substantially All of the Activities Involve or Are Conducted on Behalf of a Reporting Entity and Its Related Parties

A legal entity is a VIE if (1) it has an investor that has disproportionately few voting rights relative to that investor's economic exposure to the legal entity and (2) substantially all of the activities of the legal entity either involve or are conducted on behalf of the investor (including that investor's related parties and some de facto agents) with disproportionately few voting rights (see Section 5.4.2 for more information). All related entities under ASC 850, and all but one de facto agency relationship, must be included in the assessment of whether the “substantially all” criterion (criterion (2) above) is met. Only de facto agency relationships created by transfer restrictions as described in Section 8.2.3.4 should be excluded in the performance of this assessment.

8.3.7 Identifying a VIE’s Primary Beneficiary

As discussed in Section 7.3.5, interests of related parties must be considered in the evaluation of whether a single decision maker possesses the economics criterion (i.e., the second characteristic of a controlling financial interest) if the reporting entity has an interest in the related party. Table 8-3 indicates when such interests should be included in the evaluation.
### Table 8-3 — Inclusion of Related-Party Interests in the Economics-Criterion Evaluation

<table>
<thead>
<tr>
<th>Decision Maker’s Interests</th>
<th>Entities Under Common Control</th>
<th>Other Related Parties</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Always</strong> include the direct interests held by the decision maker in its evaluation.</td>
<td>Include the related party’s proportionate interest (see Section 7.3.5.1 for additional information) if the decision maker has a variable interest in the related party under common control (see Section 8.2.2 for definition of common control). In other words, any interests held by related parties under common control would be ignored in the individual assessment of the economics criterion if the decision maker does not have a variable interest in the related party.</td>
<td>Include the decision maker’s indirect exposure through its related parties and de facto agents (including employees and benefit plans) if the decision maker has a variable interest in the related party. In other words, any interests held by related parties and de facto agents would be ignored in the individual assessment of the economics criterion if the decision maker does not have a variable interest in the related party.</td>
</tr>
</tbody>
</table>

If neither the reporting entity nor its related parties (including de facto agents) individually possess the characteristics of a primary beneficiary on their own, the reporting entity must consider all related parties and de facto agents (even if the reporting entity does not have a variable interest in the related party or de facto agent) in analyzing whether one of the parties should consolidate under ASC 810-10-25-44 through 25-44B. See Section 7.4.2 for more information.
9.1 Reconsideration Events

<table>
<thead>
<tr>
<th>ASC 810-10</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>35-4</strong> A legal entity that previously was not subject to the Variable Interest Entities Subsections shall not become subject to them simply because of losses in excess of its expected losses that reduce the equity investment. The initial determination of whether a legal entity is a VIE shall be reconsidered if any of the following occur:</td>
</tr>
<tr>
<td>a. The legal entity's governing documents or contractual arrangements are changed in a manner that changes the characteristics or adequacy of the legal entity's equity investment at risk.</td>
</tr>
<tr>
<td>b. The equity investment or some part thereof is returned to the equity investors, and other interests become exposed to expected losses of the legal entity.</td>
</tr>
<tr>
<td>c. The legal entity undertakes additional activities or acquires additional assets, beyond those that were anticipated at the later of the inception of the entity or the latest reconsideration event, that increase the entity's expected losses.</td>
</tr>
<tr>
<td>d. The legal entity receives an additional equity investment that is at risk, or the legal entity curtails or modifies its activities in a way that decreases its expected losses.</td>
</tr>
<tr>
<td>e. Changes in facts and circumstances occur such that the holders of the equity investment at risk, as a group, lose the power from voting rights or similar rights of those investments to direct the activities of the entity that most significantly impact the entity's economic performance.</td>
</tr>
</tbody>
</table>

A reporting entity is required to reconsider whether a legal entity is a VIE upon the occurrence of certain types of events (“reconsideration events”). The reporting entity should not reconsider whether a legal entity is a VIE on a continual basis or at times other than those outlined in ASC 810-10-35-4. (Note that as discussed in Section 7.1.5, if a legal entity is a VIE, the reporting entity should continually assess whether to consolidate the VIE.)

Five types of events lead to reconsideration of VIE status, each of which is illustrated in the examples in this chapter. If one or more reconsideration events occur, the holder of a variable interest in a legal entity that was previously deemed a VIE must reconsider whether that legal entity continues to be a VIE. Likewise, the holder of a variable interest in a legal entity that previously was not a VIE must reconsider whether that legal entity has become a VIE.

A reporting entity must consider all pertinent facts and circumstances in assessing whether a reconsideration event has occurred. Insignificant events do not always result in reconsideration of a legal entity's VIE status. An event's significance depends on whether the event appears to have changed the sufficiency of equity investment at risk or on whether the characteristics of the equity investment at risk have changed.

The FASB has noted that losses in excess of expectations should not in isolation be considered a reconsideration event. However, many times, a legal entity's prolonged losses can result in the triggering of one or more of the reconsideration events in other ways (see Section 9.2.3).
A legal entity can become a VIE or cease being a VIE as a result of a reconsideration event under ASC 810-10-35-4. Such an event could also cause a reporting entity to no longer qualify or begin to qualify for one of the scope exceptions in ASC 810-10-15-12 and ASC 810-10-15-17 (see Sections 3.3 and 3.4, respectively). Upon reconsideration, the variable interest holders would need to consider all of the requirements of ASC 810-10-15-14 in determining whether the legal entity is a VIE.

### 9.1.1 Change in Governing Documents or Contractual Agreements

ASC 810-10-35-4(a) The legal entity's governing documents or contractual arrangements are changed in a manner that changes the characteristics or adequacy of the legal entity's equity investment at risk.

A reporting entity must reconsider its initial determination of whether a legal entity is a VIE if modifications have been made to the legal entity's governing documents, or to contractual arrangements, that result in changes to the characteristics or adequacy of the legal entity's equity investment at risk.

**Example 9-1**

A privately held partnership was formed with a contribution of capital from the partners in equal portions to their ownership interests. At inception, the partnership was deemed not to be a VIE. After inception, the partners wanted to protect themselves against the decline in value of the partnership's sole asset, a rental property. Therefore, the partners paid a premium to a third party for a first-loss residual value guarantee on the partnership's rental property. In this situation, the residual value guarantee has changed the characteristics of the partnership's equity investment at risk. This causes the reporting entity to reconsider whether the partnership is a VIE (specifically, it appears that the partnership no longer meets the characteristic in ASC 810-10-15-14(b)(2)) because the equity group does not absorb the expected losses related to the decline of the rental property.

### 9.1.2 Return of Equity Investment and Exposure to Losses by Other Interests

ASC 810-10-35-4(b) The equity investment or some part thereof is returned to the equity investors, and other interests become exposed to expected losses of the legal entity.

If the equity investment at risk, or some part thereof, is returned to the equity investors, each potential variable interest holder must determine whether other interests (new or preexisting) have become exposed to expected losses of the legal entity. Other interest holders become exposed to expected losses if the equity, at the time of the reconsideration, would not be sufficient to permit the legal entity to finance its activities without additional subordinated financial support, as described in ASC 810-10-15-14(a), given the circumstances and conditions at the time of the reconsideration.

The return of the equity investment at risk, or some part thereof, in and of itself, is not a reconsideration event. There may be situations in which distribution of equity does not trigger the need to reconsider whether a legal entity is a VIE (see Example 9-3). A reconsideration event occurs when a distribution of equity (or some part thereof) is in excess of accumulated earnings of the legal entity and therefore exposes other variable interest holders to expected losses, thus calling into question whether the entity's remaining equity investment at risk is sufficient. This determination may be based on a qualitative evaluation, a quantitative evaluation, or a combination of both, as discussed in Section 5.2.
Example 9-2

Enterprise A owns 49 percent of the common voting shares of Entity B, a voting interest entity. Enterprise A does not control B and does not consolidate B’s accounts under the voting interest entity model. Entity B finances its operations by issuing equity and debt (rated investment-grade by a nationally recognized rating agency). Entity B does not have any other variable interest holders besides the equity holders and the lender. When A first became involved with B, A concluded that B was a voting interest entity partly on the basis of a conclusive qualitative assessment of the sufficiency of B’s equity investment at risk.

One year after A made its investments in B, B makes a partial return of the common shareholders’ investment. Therefore, A needs to reassess whether other variable interest holders have become exposed to expected losses of B. Assume that A makes a qualitative assessment, noting that the rating agency has reaffirmed its investment-grade rating of B’s debt. This and other pertinent factors could lead to a conclusive qualitative assessment that B continues to be a voting interest entity that is not subject to the VIE model.

Example 9-3

Assume the same facts as in Example 9-2, except B finances its operations solely through equity at risk. Entity B has accumulated retained earnings of $100,000 from operations and makes a $50,000 dividend distribution to the common shareholders. Entity A does not need to reassess whether other variable interest holders have become exposed to expected losses of B since the return of equity is not in excess of accumulated earnings. Accordingly, the return of $50,000 would not trigger the need to reconsider whether B is a VIE.

9.1.3 Additional Activities or Acquisition of Additional Assets

ASC 810-10

35-4(c) The legal entity undertakes additional activities or acquires additional assets, beyond those that were anticipated at the later of the inception of the entity or the latest reconsideration event, that increase the entity’s expected losses.

The legal entity may undertake additional activities or acquire assets that were not contemplated as part of the design of the legal entity (or at a later reconsideration event) that result in an increase of its expected losses. When assessing the expected losses of the legal entity, a reporting entity should consider whether the expected losses immediately before undertaking additional activities or acquiring additional assets have increased as a result of the change that was not initially anticipated (i.e., the expected losses were not included in the reporting entity’s initial assessment of whether the legal entity is a VIE). The reporting entity will typically be able to make this determination by qualitatively analyzing the impact that the change has on expected losses on the basis of the relative risk of the additional activities or additional assets.

Example 9-4

Real Estate Entity R, initially determined not to be a VIE, purchases five rental properties by issuing equity and debt instruments. At inception, the equity and debt holders determine that the equity investment at risk is sufficient under ASC 810-10-15-14(a) and ASC 810-10-25-45. Subsequently, R issues subordinated debt to purchase additional rental properties. Because of R’s acquisition of additional assets, which potentially increases R’s expected losses, the variable interest holders involved must reconsider whether R has become a VIE. These transactions were not anticipated when R was formed.

Note that had these transactions been anticipated, in assessing the sufficiency of the equity, R would have needed to consider the variability associated with the substantial uncertainty regarding the acquisition of unidentified real estate at inception as well as the sources of funding for the acquisition. See Section 5.2.3 for additional information.
Example 9-5

Entity C is formed by two investors to develop and manufacture a new drug. Assume that C is a voting interest entity and that each investor holds a variable interest in C. Investor A has power over the research and development activities to develop and obtain FDA approval for the drug (stage 1), and those activities most significantly affect C’s economic performance during that stage. Investor B has the power over the manufacturing process, distribution, and marketing of the drug if and when FDA approval is obtained (stage 2), and those activities would most significantly affect C’s economic performance during that stage. The variable interest holders conclude that FDA approval would be considered a substantive contingent event that results in a change in power from Investor A to Investor B. Therefore, the VIE determination should focus on stage 1 activities until the contingent event occurs.

If FDA approval is obtained, C is considered to be undertaking additional activities when C enters stage 2. This is due to the substantive contingency of getting FDA approval, even though stage 2 was anticipated at C’s inception. Therefore, the reporting entity should reconsider whether C is a VIE. Conversely, if FDA approval was not considered a substantive contingency, the reporting entity would not reconsider whether C is a VIE because stage 2 activities would have been considered in the initial assessment. See Section 5.2.4 for additional information.

9.1.4 Additional Equity Investment at Risk or Modification/Curtailment of Activities

ASC 810-10

35-4(d) The legal entity receives an additional equity investment that is at risk, or the legal entity curtails or modifies its activities in a way that decreases its expected losses.

Upon the contribution of additional equity investment at risk or the modification or curtailment of a legal entity’s activities that result in a reduction of expected losses, a reporting entity should reassess whether the legal entity is a VIE.

Example 9-6

Three investors form Entity A to purchase real estate property. Each of the three investors contributes $5 million in equity investment at risk and $45 million in subordinated debt. Entity A was deemed a VIE because of insufficient equity investment at risk. The original governing documents stipulate that, 12 months after A’s formation, each investor must contribute an additional $25 million in equity investment at risk. When that additional equity investment is made, A’s VIE status is reconsidered, even though the original governing documents required the subsequent equity investment.

Example 9-6A

Three investors form Entity A. They designed A to purchase five specific real estate properties. Each investor contributes $5 million in equity investment at risk and $45 million in subordinated debt. Entity A was deemed a VIE because of insufficient equity investment at risk. Upon A’s formation, it purchases the five properties it was designed to purchase. Three of the properties are in stable markets with stable cash flows. However, two are in emerging markets in which stable cash flows are not expected, which could result in significant expected losses. Twelve months after Entity A’s formation, A sells the two properties in emerging markets, which reduces its expected losses. Upon the sale of the two properties, A’s VIE status is reconsidered.
9.1.5 Loss of Power

ASC 810-10

35-4(e) Changes in facts and circumstances occur such that the holders of the equity investment at risk, as a group, lose the power from voting rights or similar rights of those investments to direct the activities of the entity that most significantly impact the entity's economic performance.

When equity holders, as a group, lose the power to direct the most significant activities of the legal entity, the reporting entity must reconsider whether the legal entity is a VIE. While the guidance refers specifically to situations in which holders of the equity investment at risk, as a group, lose power to direct the activities of the legal entity, we believe that a reassessment of whether the entity is a VIE can sometimes be triggered when equity holders gain the power to direct the most significant activities of the legal entity.

Example 9-7

Upon formation, a limited partnership is a VIE because the general partner, along with legal entities under common control or parties acting on its behalf, has sufficient interests to prevent a simple majority (or a lower threshold) of the limited partners from exercising kick-out rights (including liquidation rights) and the limited partners do not have substantive participating rights. After the formation of the limited partnership, the governing documents are amended to permit a simple majority of the limited partners, excluding the general partner (and entities under common control or parties acting on its behalf), to exercise the kick-out rights that accrue to those interest holders irrespective of the holdings of the general partner.

The partners should reassess whether the limited partnership continues to be a VIE. In this example, the holders of the equity investment at risk (i.e., the limited partners) effectively gain power as a result of the general partner's disposal of its kick-out rights as opposed to losing the power to direct activities (as would be the case if the general partner obtained additional kick-out rights). Furthermore, even though the general partner was initially (upon formation of the partnership) and continues to be part of the equity group, we believe that the right to exercise power over the significant activities of a legal entity is fundamental to the determination of whether a legal entity is a VIE and, if so, whether the holder of a variable interest in the VIE is the primary beneficiary. Accordingly, either a gain or a loss of power to direct the activities of a limited partnership that most significantly affect its economic performance would be deemed a reconsideration event in the context of evaluating the guidance in ASC 810-10-35-4(e).

Example 9-8

Investors X and Y form Entity Z to purchase and operate real estate properties. Each investor contributes $25 million in equity at risk. In addition, Investor D loans $5 million to Z. The loan agreement between D and Z includes a clause stipulating that if there is an adverse change that materially impairs the ability of Z to pay back the loan, D can take possession of all the assets of Z and direct the activities that most significantly affect Z's economic performance. An independent third party must objectively determine whether a material adverse change has occurred on the basis of the terms of the loan agreement (an example of a material adverse change under the loan agreement would be the bankruptcy of Z). At inception, Z is deemed a voting interest entity (the rights of D are considered protective rights in accordance with ASC 810-10-25-38C). The occurrence of a material adverse change under the debt agreement would trigger a reconsideration event, since the holders of the equity investment at risk as a group would have lost the power to direct the activities that most significantly affect Z's economic performance.
Example 9-9

An investment manager creates a fund and retains a 25 percent interest in it. For its role, the investment manager receives remuneration that is customary and commensurate with services performed, including an incentive fee. However, the fee arrangement is considered a variable interest as a result of the investment manager's 25 percent interest.

In addition, the investment manager has the power to direct the activities that most significantly affect the legal entity's economic performance (rather than the equity investors). Accordingly, when evaluating whether the fund is a VIE, the investors with equity at risk would not have power (ASC 810-10-15-14(b)(1)). In this case, the investment manager would not be able to apply the override in ASC 810-10-15-14(b)(1) because its fee arrangement is a variable interest (see Section 5.3.1.1.3.1). That is, the investment manager with power would not be acting in a fiduciary capacity on behalf of the equity investors and the fund is therefore a VIE.

Subsequently, the investment manager disposes of its 25 percent interest. As a result, the fee arrangement is no longer considered a variable interest (see Section 4.4.3), and the investment manager is now acting in a fiduciary capacity on behalf of the equity investors. In this case, the investment manager would reconsider whether the fund remains a VIE because a gain or a loss of power to direct the significant activities by the equity investors would be deemed a reconsideration event in the context of evaluating the guidance in ASC 810-10-35-4(e).

9.2 Other Reconsideration Event Considerations

9.2.1 Entering Into or Emerging From Bankruptcy

Generally, the act of filing for bankruptcy is a reconsideration event. This is because entering into bankruptcy will often result in the loss of the equity investors’ ability to direct the activities of the legal entity that most significantly affect the legal entity’s economic performance (generally, this ability would reside with the bankruptcy court) which is a reconsideration event (see Section 9.1.5).

Emerging from bankruptcy is also a reconsideration event. In a majority of cases, when a legal entity emerges from bankruptcy, its governing documents generally establish new equity and other contractual arrangements that change the characteristics of the legal entity's equity investment at risk (see Section 9.1.1). In this situation, a reporting entity that holds a variable interest in the legal entity must reconsider its original conclusion related to that legal entity's VIE status.

9.2.2 Valuation of Equity Investment at Risk When a Reconsideration Event Occurs

If it is determined that a reconsideration event has occurred, a reporting entity should measure equity investment at risk in determining its sufficiency. In a manner consistent with the analysis in Section 5.2.3, a reporting entity should use the fair value of the equity investment at risk as of the reconsideration date, not the carrying value of the equity investment at risk, in determining the sufficiency of equity investment at risk.

9.2.3 Operating Losses

ASC 810-10-35-4 indicates that operating losses incurred by a legal entity that are in excess of its expected losses that result in a reduction of the equity investment at risk generally do not cause a legal entity to be subject to the VIE guidance. Said differently, if the amount of the equity investment at risk at the legal entity’s inception (or when a reporting entity first became involved with the legal entity) was determined to be sufficient, losses later incurred by that legal entity do not by themselves result in the requirement for a reporting entity to reconsider whether the legal entity has sufficient equity investment at risk. However, there may be situations in which significant losses may call into question whether the
power to direct the most significant activities of the legal entity still rest with the holders of the equity investment at risk. This may occur, for example, when significant losses result in a violation of a covenant that allows the debt holder or a guarantor to obtain a controlling financial interest in the legal entity. This would be deemed a reconsideration event under ASC 810-10-35-4(e) (see Section 9.1.5). In addition, a legal entity may initiate other changes to the governing documents or contractual arrangements, issue additional equity interests, or change its activities, which could be reconsideration events.

**Example 9-10**

Company X was formed on January 15, 20X5. As of that date, all variable interest holders determined that X had sufficient equity investment at risk (i.e., X is not a VIE). Company X incurred significant operating losses for its first two years of operations. On January 15, 20X7, X had insufficient equity investment at risk. However, no event causing reconsideration under ASC 810-10-35-4 has occurred.

On January 16, 20X7, the governing documents of X were changed. The variable interest holders determined that the change in the governing documents did not cause a change in the amount of the equity investment at risk. Even though X has insufficient equity investment at risk on January 16, 20X7, the insufficiency was caused by operating losses, not by the change in governing documents. Therefore, a reconsideration event has not occurred.
Chapter 10 — Initial and Subsequent Measurement

10.1 Initial Measurement

ASC 810-10

30-1 If the primary beneficiary of a variable interest entity (VIE) and the VIE are under common control, the
primary beneficiary shall initially measure the assets, liabilities, and noncontrolling interests of the VIE at
amounts at which they are carried in the accounts of the reporting entity that controls the VIE (or would be
carried if the reporting entity issued financial statements prepared in conformity with generally accepted
accounting principles [GAAP]).

Entities Not Under Common Control
30-2 The initial consolidation of a VIE that is a business is a business combination and shall be accounted for in
accordance with the provisions in Topic 805.

All Primary Beneficiaries
30-3 When a reporting entity becomes the primary beneficiary of a VIE that is not a business, no goodwill shall
be recognized. The primary beneficiary initially shall measure and recognize the assets (except for goodwill) and
liabilities of the VIE in accordance with Sections 805-20-25 and 805-20-30. However, the primary beneficiary
initially shall measure assets and liabilities that it has transferred to that VIE at, after, or shortly before the date
that the reporting entity became the primary beneficiary at the same amounts at which the assets and liabilities
would have been measured if they had not been transferred. No gain or loss shall be recognized because of
such transfers.

30-4 The primary beneficiary of a VIE that is not a business shall recognize a gain or loss for the difference
between (a) and (b):
   a. The sum of:
      1. The fair value of any consideration paid
      2. The fair value of any noncontrolling interests
      3. The reported amount of any previously held interests
   b. The net amount of the VIE’s identifiable assets and liabilities recognized and measured in accordance
      with Topic 805.

For a reporting entity that is deemed to be the primary beneficiary of a VIE (see Chapter 7 for a
discussion of the requirements for identifying the primary beneficiary), ASC 810-10-30 describes how
the assets, liabilities, and noncontrolling interests of the VIE should be initially measured, which can
differ depending on the relationship between the primary beneficiary and the VIE.

10.1.1 VIEs Under Common Control

If the primary beneficiary of a VIE and the VIE are under common control, the assets, liabilities, and
noncontrolling interests of the VIE should be recorded initially at their previous carrying amounts (i.e., a
carryover basis should be used with no adjustment to current fair values, and no gain or loss should be
recognized) in a manner consistent with the accounting under ASC 805-50-30 for transactions between
legal entities under common control.

10.1.2 VIEs Not Under Common Control

Assets, liabilities, and noncontrolling interests of a VIE that is a business and is not under common
control must be measured by the primary beneficiary in accordance with ASC 805-20 and ASC 805-30.
Accordingly, the assets, liabilities, and noncontrolling interests of the VIE are measured at fair value
as of the date the reporting entity was determined to be the primary beneficiary, which includes the
recognition of goodwill, if any. The primary beneficiary should not recognize goodwill if the VIE is not a
business.

The legal entity's failure to meet the business scope exception does not mean that the legal entity does
not qualify as a business for this purpose. The determination of whether a legal entity is a business
under ASC 810-10-30-2 is strictly related to whether the legal entity qualifies as a business under ASC
805-10-20. That is, even if the scope exception for a business is not applicable because one or more of
the four additional conditions in that paragraph are met, as long as the definition of a business in ASC
805-10-20 is met, goodwill, if any, should be recorded (see Section 3.4.4 for a discussion of the business
scope exception).

The primary beneficiary of a VIE that is not a business should initially measure and recognize the
assets and liabilities of the VIE in accordance with ASC 805-20-25 and ASC 805-20-30, and no goodwill
should be recognized. Although goodwill cannot be recognized, and a gain or loss is calculated on
the basis of the requirements in ASC 810-10-30-4, the primary beneficiary generally should recognize
100 percent of the identifiable assets acquired (excluding goodwill), the liabilities assumed, and any
noncontrolling interests, at fair value as though the VIE was a business and subject to the business
combination guidance requirements for recognition and measurement. This may include the recognition
of in-process research and development activities or contingent consideration obligations at fair value
upon acquisition and initial consolidation.

However, to prevent the improper recognition of gains or losses due to transfers of assets and liabilities
to VIEs, the FASB provided the guidance in ASC 810-10-30-3, which requires a legal entity that transfers
assets and liabilities to a VIE that is not a business shortly before, in connection with, or shortly after
becoming the VIE's primary beneficiary, to measure the assets and liabilities transferred to the VIE (and
only those assets and liabilities) at carrying value. All other assets (excluding goodwill), liabilities, and
noncontrolling interests should be measured in accordance with ASC 805-20-25 and ASC 805-20-30.

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1 ASC 805-10-55-3A defines a business as “[a]n integrated set of activities and assets that is capable of being conducted and managed for the
purpose of providing a return in the form of dividends, lower costs, or other economic benefits directly to investors or other owners, members, or
participants.” ASC 805-10-55-4 through 55-9 provide additional guidance on what constitutes a business. See Section 3.4.4.2 for a discussion of
ASU 2017-01, which narrowed the definition of a business.
10.1.3 Initial Measurement of Collateralized Financing Entities

ASC 810-10

15-17D The guidance on collateralized financing entities in this Topic provides a measurement alternative to Topic 820 on fair value measurement and applies to a reporting entity that consolidates a collateralized financing entity when both of the following conditions exist:

a. All of the financial assets and the financial liabilities of the collateralized financing entity are measured at fair value in the consolidated financial statements under other applicable Topics, other than financial assets and financial liabilities that are incidental to the operations of the collateralized financing entity and have carrying values that approximate fair value (for example, cash, broker receivables, or broker payables).

b. The changes in the fair values of those financial assets and financial liabilities are reflected in earnings.

30-10 When a reporting entity initially consolidates a variable interest entity that is a collateralized financing entity that meets the scope requirements in paragraph 810-10-15-17D, it may elect to measure the financial assets and the financial liabilities of the collateralized financing entity using a measurement alternative to Topic 820 on fair value measurement.

30-11 Under the measurement alternative, the reporting entity shall measure both the financial assets and the financial liabilities of the collateralized financing entity using the more observable of the fair value of the financial assets and the fair value of the financial liabilities. Any gain or loss that results from the initial application of this measurement alternative shall be reflected in earnings and attributed to the reporting entity in the consolidated statement of income (loss).

30-12 If the fair value of the financial assets of the collateralized financing entity is more observable, those financial assets shall be measured at fair value. The financial liabilities shall be measured in the initial consolidation as the difference between the following two amounts:

a. The sum of:
   1. The fair value of the financial assets
   2. The carrying value of any nonfinancial assets held temporarily

b. The sum of:
   1. The fair value of any beneficial interests retained by the reporting entity (other than those that represent compensation for services)
   2. The reporting entity's carrying value of any beneficial interests that represent compensation for services.

The fair value of the financial assets in (a)x1 should include the carrying values of any financial assets that are incidental to the operations of the collateralized financing entity because the financial assets' carrying values approximate their fair values.
30-13 If the fair value of the financial liabilities of the collateralized financing entity is more observable, those financial liabilities shall be measured at fair value. The financial assets shall be measured in the initial consolidation as the difference between the following two amounts:

   a. The sum of:
      1. The fair value of the financial liabilities (other than the beneficial interests retained by the reporting entity)
      2. The fair value of any beneficial interests retained by the reporting entity (other than those that represent compensation for services)
      3. The reporting entity's carrying value of any beneficial interests that represent compensation for services

   b. The carrying value of any nonfinancial assets held temporarily.

The fair value of the financial liabilities in (a)(1) should include the carrying values of any financial liabilities that are incidental to the operations of the collateralized financing entity because the financial liabilities' carrying values approximate their fair values.

30-14 The amount resulting from paragraph 810-10-30-12 or paragraph 810-10-30-13 shall be allocated to the less observable of the financial assets and financial liabilities (other than the beneficial interests retained by the reporting entity), as applicable, using a reasonable and consistent methodology.

30-15 The carrying value of the beneficial interests that represent compensation for services (for example, rights to receive management fees or servicing fees) and the carrying value of any nonfinancial assets held temporarily by the collateralized financing entity shall be measured in accordance with other applicable Topics.

30-16 If a reporting entity does not elect to apply the measurement alternative to a collateralized financing entity that meets the scope requirements in paragraph 810-10-15-17D, the reporting entity shall measure the fair value of the financial assets and the fair value of the financial liabilities of the collateralized financing entity using the requirements of Topic 820 on fair value measurement. If Topic 820 is applied, any initial difference in the fair value of the financial assets and the fair value of the financial liabilities of the collateralized financing entity shall be reflected in earnings and attributed to the reporting entity in the consolidated statement of income (loss).

The FASB issued ASU 2014-13 (as codified above) to eliminate the measurement differences that sometimes arise when financial assets and financial liabilities of a CFE are measured at fair value under the requirements of ASC 820. ASU 2014-13 provides a measurement alternative to ASC 820 for entities that consolidate CFEs. Under this alternative, a reporting entity may elect to measure both the CFE's assets and its liabilities by using the fair value of the more observable of either the CFE's financial assets or its financial liabilities, thus eliminating the measurement differences between the financial assets and financial liabilities.

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2ASC 810-10-20 defines a CFE as “[a] variable interest entity that holds financial assets, issues beneficial interests in those financial assets, and has no more than nominal equity. The beneficial interests have contractual recourse only to the related assets of the collateralized financing entity and are classified as financial liabilities. A collateralized financing entity may hold nonfinancial assets temporarily as a result of default by the debtor on the underlying debt instruments held as assets by the collateralized financing entity or in an effort to restructure the debt instruments held as assets by the collateralized financing entity. A collateralized financing entity also may hold other financial assets and financial liabilities that are incidental to the operations of the collateralized financing entity and have carrying values that approximate fair value (for example, cash, broker receivables, or broker payables).”
10.2 Subsequent Measurement

ASC 810-10

35-3 The principles of consolidated financial statements in this Topic apply to primary beneficiaries' accounting for consolidated variable interest entities (VIEs). After the initial measurement, the assets, liabilities, and noncontrolling interests of a consolidated VIE shall be accounted for in consolidated financial statements as if the VIE were consolidated based on voting interests. Any specialized accounting requirements applicable to the type of business in which the VIE operates shall be applied as they would be applied to a consolidated subsidiary. The consolidated entity shall follow the requirements for elimination of intra-entity balances and transactions and other matters described in Section 810-10-45 and paragraphs 810-10-50-1 through 50-1B and existing practices for consolidated subsidiaries. Fees or other sources of income or expense between a primary beneficiary and a consolidated VIE shall be eliminated against the related expense or income of the VIE. The resulting effect of that elimination on the net income or expense of the VIE shall be attributed to the primary beneficiary (and not to noncontrolling interests) in the consolidated financial statements.

After initial measurement, the assets, liabilities, and noncontrolling interests of a consolidated VIE should be accounted for in the primary beneficiary's consolidated financial statements “as if the VIE were consolidated based on voting interests,” as described in ASC 810-10-35. The primary beneficiary is subject to the reporting and disclosure requirements discussed in Chapter 11, as applicable.

10.2.1 Intercompany Considerations

ASC 810-10-45-1 and ASC 810-10-45-18 require intercompany balances and transactions to be eliminated in their entirety. The amount of profit or loss eliminated would not be affected by the existence of a noncontrolling interest (e.g., intra-entity open accounts balances, security holdings, sales and purchases, interest, or dividends). Since consolidated financial statements are based on the assumption that they represent the financial position and operating results of a single economic entity, the consolidated statements would not include any gain or loss transactions between the entities in the consolidated group.

ASC 810-10-45-18 further states that the “elimination of the intra-entity income or loss may be allocated between the parent and noncontrolling interests.” However, ASC 810-10-35-3 contains additional guidance on the effect of certain intercompany eliminations when an entity consolidates a VIE. It states, in part: “Fees or other sources of income or expense between a primary beneficiary and a consolidated VIE shall be eliminated against the related expense or income of the VIE. The resulting effect of that elimination on the net income or expense of the VIE shall be attributed to the primary beneficiary (and not to noncontrolling interests) in the consolidated financial statements.”

On a consolidated basis, the primary beneficiary will continue to eliminate intercompany amounts received from or paid to a consolidated VIE. After elimination, these amounts will not be included in revenue or other income. However, the effect (i.e., the benefit or obligation) of these amounts received from or paid to the VIE still should be recognized in net income attributable to the primary beneficiary, as illustrated in Example 10-1.
Example 10-1

Company X is a VIE capitalized by an equity investment of $10 from Enterprise Y and a loan of $990 from Enterprise Z. Enterprise Z has determined that it is the primary beneficiary of X. Each year, Z recognizes $75 of interest income as a result of its 7.6 percent interest rate on the debt.

Because X is a VIE, the guidance in ASC 810-10-35-3 should be applied. The table below illustrates the impact on Z's financial statements of accounting for intercompany eliminations under ASC 810-10-35-3.

<table>
<thead>
<tr>
<th></th>
<th>Z</th>
<th>X</th>
<th>Consolidating Entries</th>
<th>Consolidated Z</th>
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</thead>
<tbody>
<tr>
<td>Sales</td>
<td>$ 15,000</td>
<td>$ 1,500</td>
<td>$ —</td>
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<td>13,000</td>
<td>1,300</td>
<td>—</td>
<td>14,300</td>
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<td>Gross margin</td>
<td>2,000</td>
<td>200</td>
<td>—</td>
<td>2,200</td>
</tr>
<tr>
<td>Other income (expense)</td>
<td></td>
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<td></td>
<td></td>
</tr>
<tr>
<td>Interest income</td>
<td>75</td>
<td>—</td>
<td>(75)*</td>
<td>—</td>
</tr>
<tr>
<td>Interest expense</td>
<td>—</td>
<td>(75)</td>
<td>75*</td>
<td>—</td>
</tr>
<tr>
<td>Net income</td>
<td>2,075***</td>
<td>125</td>
<td>—</td>
<td>2,200</td>
</tr>
<tr>
<td>Net income attributable to Y (the noncontrolling interest holder)</td>
<td>$ —</td>
<td>$ —</td>
<td>$ (125)**</td>
<td>(125)</td>
</tr>
<tr>
<td>Net income attributable to Z</td>
<td>$ 2,075***</td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

* Intercompany revenue and expense between X and Z are eliminated.

** Net income of X, including the effect of interest expense, is attributable to Y, the noncontrolling interest holder, as follows:

- Gross margin of X: $ 200
- Interest expense: (75)
- Net income attributable to Y: $ 125

Under the ASC 810-10-35-3 approach, the effect of eliminating intercompany interest income or expense has been attributed to Z (the primary beneficiary) rather than Y (the noncontrolling interest holder). Enterprise Z's interest income has been eliminated, and net income attributable to the noncontrolling interest holder includes the effect of the $75 interest expense.

*** Net income attributable to Z remains unchanged from the $2,075 net income reported in Z's stand-alone financial statements. This result reflects that the legal right of Y (the noncontrolling interest holder) to net income is limited to $125.
Example 10-1 (continued)

To better understand the unique aspects of accounting for intercompany eliminations under the VIE model, consider the table below, which shows how such eliminations would be accounted for if X were a voting interest entity. If the voting interest entity model were used, the effect of eliminating intercompany interest income or expense would be allocated in proportion to equity ownership. Since Z does not have an equity interest in X, all income after eliminations would be allocated to the noncontrolling interest. For comparative purposes only, assume that in a manner similar to the example above, Z consolidates X (despite not having an equity interest in X).

<table>
<thead>
<tr>
<th></th>
<th>Z</th>
<th>X</th>
<th>Consolidating Entries</th>
<th>Consolidated Z</th>
</tr>
</thead>
<tbody>
<tr>
<td>Sales</td>
<td>$ 15,000</td>
<td>$ 1,500</td>
<td>—</td>
<td>$ 16,500</td>
</tr>
<tr>
<td>Cost of sales</td>
<td>13,000</td>
<td>1,300</td>
<td>—</td>
<td>14,300</td>
</tr>
<tr>
<td>Gross margin</td>
<td>2,000</td>
<td>200</td>
<td>—</td>
<td>2,200</td>
</tr>
<tr>
<td>Other income (expense)</td>
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<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Interest income</td>
<td>75</td>
<td>—</td>
<td>(75)*</td>
<td>—</td>
</tr>
<tr>
<td>Interest expense</td>
<td>—</td>
<td>—</td>
<td>(75)</td>
<td>75*</td>
</tr>
<tr>
<td>Net income</td>
<td>2,075***</td>
<td>125</td>
<td>—</td>
<td>2,200</td>
</tr>
<tr>
<td>Net income attributable to Y (the noncontrolling interest holder)</td>
<td>$ —</td>
<td>$ —</td>
<td>$ (200)**</td>
<td>$(200)</td>
</tr>
<tr>
<td>Net income attributable to Z</td>
<td></td>
<td></td>
<td></td>
<td>$ 2,000***</td>
</tr>
</tbody>
</table>

* Intercompany revenue and expense between X and Z are eliminated.
** Net income of X is attributable to Y, the noncontrolling interest holder, as follows:

<p>| | |</p>
<table>
<thead>
<tr>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Gross margin of X</td>
<td>$ 200</td>
</tr>
<tr>
<td>Interest expense</td>
<td>(75)</td>
</tr>
<tr>
<td>Elimination of interest expense</td>
<td>75</td>
</tr>
<tr>
<td>Net income attributable to Y</td>
<td>$ 200</td>
</tr>
</tbody>
</table>

*** Under the voting interest entity model illustrated here, net income attributable to Z is $75 lower than what it is under the VIE model.

10.2.2 Subsequent Measurement of Collateralized Financing Entities

ASC 810-10

35-6 A reporting entity that elects to apply the measurement alternative to Topic 820 on fair value measurement upon initial consolidation of a collateralized financing entity that meets the scope requirements in paragraph 810-10-15-17D shall consistently apply the measurement alternative for the subsequent measurement of the financial assets and the financial liabilities of that consolidated collateralized financing entity provided that it continues to meet the scope requirements in paragraph 810-10-15-17D. If a collateralized financing entity subsequently fails to meet the scope requirements, a reporting entity shall no longer apply the measurement alternative to that collateralized financing entity. Instead, it shall apply Topic 820 to measure those financial assets and financial liabilities that were previously measured using the measurement alternative.
Under the measurement alternative, a reporting entity shall measure both the financial assets and the financial liabilities of the collateralized financing entity using the more observable of the fair value of the financial assets and the fair value of the financial liabilities, as described in paragraphs 810-10-30-12 through 30-15.

A reporting entity that applies the measurement alternative shall recognize in its earnings all amounts that reflect its own economic interests in the consolidated collateralized financing entity, including both of the following:

a. The changes in the fair value of any beneficial interests retained by the reporting entity (other than those that represent compensation for services)
b. Beneficial interests that represent compensation for services (for example, management fees or servicing fees).

If a reporting entity does not apply the measurement alternative to a collateralized financing entity that meets the scope requirements in paragraph 810-10-15-17D, the reporting entity shall measure the fair value of the financial assets and the fair value of the financial liabilities of the collateralized financing entity using the requirements of Topic 820 on fair value measurement. If Topic 820 is applied, any subsequent changes in the fair value of the financial assets and the changes in the fair value of the financial liabilities of the collateralized financing entity shall be reflected in earnings and attributed to the reporting entity in the consolidated statement of income (loss).

As discussed in Section 10.1.3, the FASB issued ASU 2014-13 to eliminate the measurement differences that occur when a CFE’s financial assets and financial liabilities are measured at fair value under the requirements of ASC 820. ASU 2014-13 provides a measurement alternative to ASC 820 for entities that consolidate CFEs. Under this alternative approach, the reporting entity may elect to measure both the CFE’s assets and liabilities by using the fair value of the more observable of either the CFE’s financial assets or its financial liabilities, thus eliminating the measurement differences between the financial assets and financial liabilities.

If a CFE does not apply the measurement alternative for CFEs, it should apply ASC 820 to measure both the financial assets and financial liabilities and reflect any differences between the fair value of a consolidated CFE’s financial assets and financial liabilities in earnings, attributing these differences to the reporting entity in the consolidated statement of income (loss).

### Acquisition of Noncontrolling Interest

Changes in a parent's ownership interest while the parent retains its controlling financial interest in its subsidiary shall be accounted for as equity transactions (investments by owners and distributions to owners acting in their capacity as owners). Therefore, no gain or loss shall be recognized in consolidated net income or comprehensive income. The carrying amount of the noncontrolling interest shall be adjusted to reflect the change in its ownership interest in the subsidiary. Any difference between the fair value of the consideration received or paid and the amount by which the noncontrolling interest is adjusted shall be recognized in equity attributable to the parent. Example 1 (paragraph 810-10-55-4B) illustrates the application of this guidance.

A change in a parent's ownership interest might occur in a subsidiary that has accumulated other comprehensive income. If that is the case, the carrying amount of accumulated other comprehensive income shall be adjusted to reflect the change in the ownership interest in the subsidiary through a corresponding charge or credit to equity attributable to the parent. Example 1, Case C (paragraph 810-10-55-4F) illustrates the application of this guidance.
As stated in Section 10.1.2, a primary beneficiary is required to measure the assets, liabilities, and noncontrolling interests of the newly consolidated entity in accordance with ASC 805 at fair value as of the date the reporting entity was deemed to be the primary beneficiary, unless the VIE does not represent a business or is under common control. A primary beneficiary’s acquisition of any noncontrolling interest should be accounted for as an equity transaction, with any difference in price paid, and the carrying amount of the noncontrolling interest reflected, directly in equity and not in net income as a gain or loss. For more information, see Deloitte’s *A Roadmap to Accounting for Noncontrolling Interests.*
11.1 Presentation

**ASC 810-10**

<table>
<thead>
<tr>
<th>45-25</th>
<th>A reporting entity shall present each of the following separately on the face of the statement of financial position:</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>a. Assets of a consolidated variable interest entity (VIE) that can be used only to settle obligations of the consolidated VIE</td>
</tr>
<tr>
<td></td>
<td>b. Liabilities of a consolidated VIE for which creditors (or beneficial interest holders) do not have recourse to the general credit of the primary beneficiary.</td>
</tr>
</tbody>
</table>

While ASC 810 contains certain presentation requirements for VIEs and noncontrolling interests, entities should generally apply other GAAP on the presentation of assets and liabilities. Presentation requirements specific to VIEs are discussed below. In addition, see Deloitte's *A Roadmap to Accounting for Noncontrolling Interests*.

### 11.1.1 Separate VIE Presentation Requirements

Under the variable interest model, a reporting entity is required to present certain qualifying assets and liabilities of a VIE separately on the face of the balance sheet. This information must be presented on a gross basis for each major class of assets and liabilities. That is, a VIE’s liabilities cannot be offset against its assets, unless permitted by other GAAP, and a VIE’s assets should not be combined as a single asset line item and its liabilities should not be combined as a single liability line item, unless this is permitted by other GAAP.

Paragraph A81 in the Basis for Conclusions of Statement 167 notes that the Board rejected a linked presentation approach that would have allowed liabilities of a VIE to be reflected as a deduction from the related assets of the VIE. Therefore, a presentation of the assets and liabilities separately but on one side of the statement of financial position would also not be appropriate. In addition, the “Board considered, but rejected, a single line-item display of those assets and liabilities” that meet the separate presentation criteria. Accordingly, the assets of the VIE (which may include, for example, cash, receivables, investments, or fixed assets) should not be combined on the face of the statement of financial position as a single line item unless they are the same category of asset (the same principle applies to liabilities of the VIE).
The VIE model does not provide additional guidance on how assets and liabilities that meet the separate presentation criteria should be presented in the statement of financial position. A reporting entity has presentation alternatives as long as the assets and liabilities that meet the separate presentation criteria appear separately on the face of the statement of financial position. For example, among other acceptable alternatives, a reporting entity may be able to present positions:

- As one line item and then parenthetically state the amount of positions that are in a VIE and that meet the separate presentation criteria.
- As one line item on the face of the balance sheet and then include a table following the consolidated balance sheet to present the assets and liabilities of the consolidated VIEs that have been included in the preceding balance sheet.
- In two separate line items (one line item for those that are in a VIE and meet the separate presentation criteria and another line item for all other receivables). However, in a manner consistent with its comment letters, the SEC staff has challenged this presentation in certain instances and required one of the other two alternatives above in accordance with SEC Regulation S-X, Rule 5-02. Therefore, SEC registrants should be aware that such presentation may be challenged; however, we understand that this challenge has not consistently been applied.

In addition, although all assets and liabilities of consolidated VIEs that meet the separate presentation criteria must be separately presented on the balance sheet, this presentation requirement does not necessarily apply to every VIE. Presenting separate line items on a reporting entity’s balance sheet for each VIE may be impractical for certain companies that consolidate numerous VIEs that meet the criteria under ASC 810-10-45-25. We believe that a reporting entity may consider the aggregation principles for disclosure in ASC 810-10-50-9 (see Section 11.2.6.1) when applying the separate presentation requirements.

Finally, we believe that in applying the aggregation principles, the reporting entity should document and disclose its accounting policy on how it considers aggregation for similar legal entities.

Further, a reporting entity is permitted, but not required, to separately present noncontrolling interests in consolidated VIEs in the equity section. However, such an election is an accounting policy choice that must be applied to all consolidated VIEs.

ASC 810-10-45-25 does not require that the changes in the assets and liabilities be separately reflected in the statement of cash flows or in the statement of operations unless this is required by other GAAP. However, a reporting entity is permitted to reflect this information separately, and such an election is an accounting policy choice that must be applied to all consolidated VIEs. In addition, the separate presentation criteria for assets are not the same as those for liabilities. Therefore, it is possible that only the assets or only the liabilities would have to be separately presented for certain entities.

### 11.1.1.1 Separate Presentation Requirements — Intercompany Eliminations

In complying with ASC 810-10-45-25, a reporting entity should first apply ASC 810-10-45-1, which states that in “the preparation of consolidated financial statements, intra-entity balances and transactions shall be eliminated. This includes intra-entity open account balances, security holdings, sales and purchases, interest, dividends, and so forth.” After the appropriate eliminations and consolidation of account balances, the reporting entity should apply the presentation requirements of ASC 810-10-45-25 to the consolidated balance sheets of the reporting entity. When identifying the assets and liabilities to be presented in accordance with that guidance, the reporting entity should consider only those assets and liabilities that continue to be presented and included in the consolidated balance sheets of a reporting entity.
entity after the principles of consolidated financial statements have been applied. A reporting entity should not gross up the assets and liabilities of a consolidated VIE to apply ASC 810-10-45-25.

**Example 11-1**

Entity A contributes $40 in cash in the form of a $10 equity investment and $30 loan to Entity B, a VIE. Entity B contributes $40 in cash for an investment in Entity C, also a VIE. Once capitalized, C borrows $160 from a third-party bank and uses the $40 contributed by B and the $160 borrowed from the bank to purchase $200 of investment-grade debt securities from third parties. The $160 borrowed from the bank is recourse only to these securities (i.e., the bank does not have recourse to the assets of A or B [B is the parent of C, and A is the parent of B]). The $200 of investment-grade debt securities may only be used to service the borrowing from the bank and, upon liquidation of C, to distribute the net assets of C to B. In addition, B and C are both VIEs, B is the primary beneficiary of C, and A is the primary beneficiary of B.

Entity A must first apply ASC 810-10-45-1 and eliminate its investment in and loan to B and then eliminate B’s investment asset in VIE C. As a result of these eliminations, no assets or liabilities of consolidated VIE B exist in the consolidated statement of financial position; therefore, no separate balance sheet presentation for these items is required under ASC 810-10-45-25. Entity A would separately identify the $200 of investment-grade debt securities and $160 of bank borrowings in its consolidated financial statements, since these items meet the conditions in ASC 810-10-45-25. The diagram below illustrates this scenario.

<table>
<thead>
<tr>
<th>Balances</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Entity A</strong></td>
</tr>
<tr>
<td>Loan receivable</td>
</tr>
<tr>
<td>Investment in B</td>
</tr>
<tr>
<td>Equity</td>
</tr>
</tbody>
</table>

| **Entity B**           |
| Investment in C        | 40 |
| Debt (held by A)       | 30 |
| Equity (held by A)     | 10 |

| **Entity C**           |
| Assets/securities      | 200 |
| Debt (held by Bank)    | 160 |
| Equity (held by B)     | 40 |

<table>
<thead>
<tr>
<th>Consolidated Balances</th>
</tr>
</thead>
<tbody>
<tr>
<td>Assets/securities — Entity C</td>
</tr>
<tr>
<td>Debt (held by Bank) — Entity C</td>
</tr>
<tr>
<td>Equity — Entity A</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Eliminations</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Entry 1</strong></td>
</tr>
<tr>
<td>Debt (held by A) — Entity B</td>
</tr>
<tr>
<td>Equity (held by A) — Entity B</td>
</tr>
<tr>
<td>Loan receivable — Entity A</td>
</tr>
<tr>
<td>Investment in B — Entity A</td>
</tr>
</tbody>
</table>

| **Entry 2** |
| Equity (held by B) — Entity C     | 40 |
| Investment in C — Entity B         | 40 |
11.1.1.2 Separate Presentation Requirements — Optional Presentation

A reporting entity may elect to separately present assets and liabilities of VIEs even if they do not meet the requirements for separate presentation in ASC 810-10-45-25. However, if a reporting entity elects to separately present assets and liabilities of a consolidated VIE that do not meet the separate presentation requirements, the face of the financial statements should clearly indicate which assets and liabilities meet the separate presentation criteria and which do not. In addition, the reporting entity should ensure that its presentation is compliant with the requirements discussed above in Section 11.1.1. Electing such a presentation is an accounting policy choice that must be applied to all consolidated VIEs.

11.1.2 Presentation of Beneficial Interest in a CFE on the Consolidated Balance Sheet

The beneficial interests in a CFE should be classified as liabilities on the balance sheet of the consolidated entity. On the basis of informal discussions with the SEC staff, we understand that the staff would object to the classification of such beneficial interests within noncontrolling equity interest on the consolidated entity’s balance sheet.

The beneficial interests in a CFE are often issued in the legal form of debt, in which case they must be classified as a liability. In certain situations, the residual interests in a CFE may be issued in the form of a share. However, the SEC staff believes that when an asset-backed financing subsidiary that is not considered a business was created simply to issue beneficial interests in financial assets, those beneficial interests should be classified as liabilities in the consolidated financial statements of the parent entity. The SEC staff discussed this issue at the 2009 AICPA Conference on Current SEC and PCAOB Developments. An SEC staff member, Professional Accounting Fellow Brian Fields, stated the following:

To say it again in another way, when a subsidiary is created simply to issue beneficial interests backed by financial assets rather than to engage in substantive business activities, we’ve concluded that sales of interests in the subsidiary should be viewed as transfers of interests in the financial assets themselves. The objective of an asset-backed financing is to provide the beneficial interest holders with rights to a portion of financial asset cash flows and the guiding literature is contained in Codification Topic 860 on transfers of financial assets. That literature requires a transfer to be reflected either as a sale or collateralized borrowing, depending on its specific characteristics — presentation as an equity interest in the reporting entity is not a possible outcome. [Emphasis added and footnote omitted]

11.1.3 Parent and Subsidiary With Different Fiscal-Year-End Dates

ASC 810-10

45-12 It ordinarily is feasible for the subsidiary to prepare, for consolidation purposes, financial statements for a period that corresponds with or closely approaches the fiscal period of the parent. However, if the difference is not more than about three months, it usually is acceptable to use, for consolidation purposes, the subsidiary’s financial statements for its fiscal period; if this is done, recognition should be given by disclosure or otherwise to the effect of intervening events that materially affect the financial position or results of operations.
A parent or an investor should report a change to (or the elimination of) a previously existing difference between the parent's reporting period and the reporting period of a consolidated entity or between the reporting period of an investor and the reporting period of an equity method investee in the parent's or investor's consolidated financial statements as a change in accounting principle in accordance with the provisions of Topic 250. While that Topic generally requires voluntary changes in accounting principles to be reported retrospectively, retrospective application is not required if it is impracticable to apply the effects of the change pursuant to paragraphs 250-10-45-9 through 45-10. The change or elimination of a lag period represents a change in accounting principle as defined in Topic 250. The scope of this paragraph applies to all entities that change (or eliminate) a previously existing difference between the reporting periods of a parent and a consolidated entity or an investor and an equity method investee. That change may include a change in or the elimination of the previously existing difference (lag period) due to the parent's or investor's ability to obtain financial results from a reporting period that is more consistent with, or the same as, that of the parent or investor. This paragraph does not apply in situations in which a parent entity or an investor changes its fiscal year-end.

If, on the basis of the primary beneficiary requirements discussed in Chapter 7, it is determined that a variable interest holder is the primary beneficiary of a VIE, the VIE will be considered a new subsidiary of the company and should be consolidated in accordance with the guidance in Chapter 10. In some situations, a VIE’s fiscal-year-end date will not be the same as the parent company’s.

A reporting entity should consider all facts and circumstances when assessing the appropriateness of reporting a subsidiary's financial results on a time lag. It is ordinarily feasible to align a subsidiary's reporting period with the parent’s; however, the guidance acknowledges that as long as the fiscal-year-end dates of the parent and subsidiary are not more than three months apart, it generally would be acceptable to use the subsidiary's financial statements for its fiscal period.

While ASC 810-10 does not specify when different fiscal-year-end dates would be appropriate, a parent should nevertheless be able to support its conclusion. For example, the parent may be able to support a different fiscal-year-end date for a subsidiary that operates in a seasonal industry in which most industry participants use a specific fiscal year. The advantages of a subsidiary's reporting date being comparable to other dates in the industry may outweigh the disadvantages of a subsidiary's fiscal-year-end date being different from the parent's. In addition, the parent may be able to support a similar conclusion for a subsidiary that cannot produce timely and reliable financial results even though it has the same closing date as the parent. For example, a calendar-year parent may have its subsidiary use a November 30 year-end simply to ensure that the subsidiary's financial information is fully compiled, reliable, and available to include in the parent’s (i.e., consolidated) annual financial statements.

If the parent and the subsidiary have different fiscal-year-end dates, the parent should consider using the best available data from the subsidiary when preparing its consolidated financial statements. The most recent information is generally preferred. Therefore, for consolidation it may be better for the parent to use the subsidiary’s financial information as of its interim date that coincides with the parent’s balance sheet date. However, sometimes year-end financial information is better than interim financial information (e.g., when the subsidiary’s system for producing interim financial information is not sufficiently reliable). If the parent concludes that the subsidiary's year-end financial information is preferable, the financial information for the subsidiary’s 12 months should be combined with that of the parent as though they had the same year-end.
The parent should evaluate material events occurring during any reporting time lag (i.e., the period between the subsidiary’s year-end reporting date and the parent’s balance sheet date) to determine whether the effects of such events should be disclosed or recorded in the parent’s financial statements under ASC 810-10-45-12, which states that “recognition should be given by disclosure or otherwise to the effect of intervening events that materially affect the [parent’s] financial position or results of operations.”

A reporting entity may elect a policy of either disclosing all material intervening events, or both disclosing and recognizing them. Either policy is acceptable and should be consistently applied to all material intervening events that meet the recognition requirements of GAAP. When a reporting entity chooses to recognize material intervening events, either in accordance with its elected policy or because the events are so significant that disclosure alone would not be sufficient (as discussed below), it should take care to reflect only the impact of such events. It would generally not be appropriate to present more than 12 months of operations for the subsidiary in the consolidated financial statements (in addition to the effects of the recognized event or another change in the parent’s accounting for the subsidiary).

If the reporting entity's policy is only to disclose material intervening events, the reporting entity may, in certain situations, be required to record some of these events in the consolidated financial statements of the parent. Examples of those situations include when the intervening event is considered (1) a recognized subsequent event in accordance with ASC 855-10-25-1 or (2) a significant intervening event (as defined in the next paragraph). A material intervening event would be considered a recognized subsequent event if it (1) occurs after the subsidiary's period-end but before the year-end of the parent's consolidated financial statements and (2) would meet the criteria for recognition under ASC 855 if the subsidiary was issuing separate stand-alone financial statements under GAAP.

Significant intervening events are unusual and are defined as events that are so significant, they must be recognized to prevent the parent’s consolidated financial statements from being misleading (e.g., the magnitude of the effect on the parent's consolidated financial statements is substantial and permanent in nature). A reporting entity should recognize such events by recording their effects in the parent's consolidated financial statements even if the reporting entity's elected policy is only to disclose material intervening events. Disclosures alone of these events would not provide financial statement users with sufficient information regarding the extent of the effect on the parent's consolidated operations. One example of a situation in which a reporting entity may be required to record the effects in the consolidated statements is when the business assets of a subsidiary, representing 50 percent of the consolidated revenue, assets, or net income, are destroyed by a natural disaster. In recognizing a significant intervening event, a reporting entity must use judgment and should consider consulting with professional accounting advisers.

This guidance applies to material (or significant) intervening events that would affect the subsidiary's financial results rather than transactions or events of the parent. For instance, if a parent sold the subsidiary during the reporting lag, the sale is a transaction of the parent. Therefore, in such circumstances, the disposal of the subsidiary should be recognized in the period in which the disposition occurs, regardless of whether a reporting lag exists. It would be inappropriate to defer recognition of the transaction at the consolidated-parent-company level because the transaction falls into a different interim or annual period for the subsidiary.
11.1.3.1 **Parent and Subsidiary With Different Fiscal-Year-End Dates — Initial Quarter After Acquisition**

In the initial quarter after a parent acquires a subsidiary whose fiscal-year-end is different from its own, the parent can use different methods, some of which are illustrated in Example 11-2 below, to apply the guidance in ASC 810-10-45-12. A reporting entity must use judgment in determining which method is appropriate and should consider consulting with professional accounting advisers.

**Example 11-2**

On June 1, a calendar-year-end parent entity acquires a subsidiary with a fiscal year ending July 31. The parent intends to record the subsidiary's earnings on a one-quarter lag. The parent's most recent quarter-end was June 30, and the subsidiary's most recent quarter-end was April 30.

**Method 1**

The parent would not record any subsidiary earnings in its results for the quarter ended June 30 because the parent had no rights to the subsidiary's results for the quarter ended April 30. In the quarter ended September 30, the parent records the subsidiary's results for the quarter ended July 31.

**Method 2**

The parent would record the subsidiary's earnings in the quarter ended June 30 on the basis of the subsidiary's results for the period from acquisition to June 30. In the quarter ended September 30, the parent would record the subsidiary's earnings on the basis of the results for the quarter ended July 31. However, the subsidiary's results for the period from acquisition to June 30 would be reversed from retained earnings (with an offset to investment in subsidiary) to properly state the parent's effects of earnings on its equity.

Assume that a subsidiary with a September 30 year-end was acquired on April 1, and the parent reports on a calendar-year-end basis. The parent would record the amount of subsidiary income for the quarters ending June 30 and September 30 (on the basis of the subsidiary's quarter ending June 30). However, for the period ended September 30, the subsidiary's results for the period from acquisition to June 30 should be reversed from retained earnings (with an offset to investment in subsidiary) to properly state the effects of the parent's earnings on its equity.

Under Method 2, it is assumed that the subsidiary can close its accounts and record accurately for the initial period and that the amounts used would present fairly the results of operations even though the subsidiary's financial data subsequently will be reported on a lag.

11.1.3.2 **Classification of a Subsidiary's Loan Payable When the Fiscal-Year-End Dates of the Parent and Subsidiary Differ**

A subsidiary's fiscal year may end before the parent's, and the subsidiary may have debt that is classified as long-term since it matures more than 12 months after the subsidiary's fiscal year-end. However, in certain circumstances, the debt matures less than 12 months after the parent's fiscal year-end. Because the loan payable matures less than 12 months after the parent's year-end, the parent should classify the loan payable as a current liability in its consolidated balance sheet. Classification as current or noncurrent is governed by the parent's fiscal year-end. As noted in ASC 470-10-S99-4, this interpretation is consistent with comments made at meetings to discuss EITF 88-15, at which the SEC observer indicated that the SEC staff would expect registrants to present such debt as current.
11.1.3.3 Elimination of a Reporting Lag Between Parent and Subsidiary

As noted in ASC 810-10-45-13, the change in or elimination of a previously existing reporting lag between a parent and a consolidated entity is a change in accounting principle under ASC 250.

ASC 250 permits a reporting entity to change an accounting principle if the reporting entity demonstrates that the newly adopted accounting principle is not only acceptable but also preferable. Although a reporting lag of up to 93 days may be acceptable, it is preferable for the fiscal period of a consolidated subsidiary's or an equity method investment's financial statements to correspond to that of its parent or investor.

A reporting entity should evaluate whether a change in accounting principle is preferable on the basis of existing authoritative literature, changes in the structure and economics of principal transactions, industry practice, business judgment, and business planning, among other sources. However, industry practice itself may not always justify the preferability of an alternative principle. Ultimately, the determination is based on the facts and circumstances related to changing or eliminating a previously existing reporting lag, and the burden of justifying a change ultimately rests with the reporting entity making the change. Reduction or elimination of a lag would generally be preferable because the change would typically:

- Provide more timely and relevant financial information to users of the consolidated financial statements.
- Reflect the results of the parent's and the subsidiary's results of operations during the same 12-month period.
- Reflect comparable seasonal data throughout all of the parent entity's operating divisions.

If a reporting entity is able to justify the preferability of a change in or elimination of a previously existing reporting lag, the reporting entity must report the change by retrospectively applying it in accordance with ASC 250-10-45-5, which states:

An entity shall report a change in accounting principle through retrospective application of the new accounting principle to all prior periods, unless it is impracticable to do so. Retrospective application requires all of the following:

a. The cumulative effect of the change to the new accounting principle on periods prior to those presented shall be reflected in the carrying amounts of assets and liabilities as of the beginning of the first period presented.

b. An offsetting adjustment, if any, shall be made to the opening balance of retained earnings (or other appropriate components of equity or net assets in the statement of financial position) for that period.

c. Financial statements for each individual prior period presented shall be adjusted to reflect the period-specific effects of applying the new accounting principle.
A reporting entity may be able to demonstrate that determining the cumulative effect of such change on any prior period is impracticable. If so, the change is applied as if it were made prospectively as of the earliest date practicable. However, the impracticability threshold is high, and an entity, in determining whether it has crossed this threshold, would have to assess whether it has satisfied the requirements in ASC 250-10-45-9, which states:

It shall be deemed impracticable to apply the effects of a change in accounting principle retrospectively only if any of the following conditions exist:

a. After making every reasonable effort to do so, the entity is unable to apply the requirement.

b. Retrospective application requires assumptions about management’s intent in a prior period that cannot be independently substantiated.

c. Retrospective application requires significant estimates of amounts, and it is impossible to distinguish objectively information about those estimates that both:
   1. Provides evidence of circumstances that existed on the date(s) at which those amounts would be recognized, measured, or disclosed under retrospective application.
   2. Would have been available when the financial statements for that prior period were issued.

For example, retrospective application of a change in or elimination of a reporting lag may be deemed impracticable if it is not feasible for the reporting entity to objectively determine assumptions related to estimates (e.g., fair value measurements, various impairment analyses) that would have been used as of the period-end date of the prior reporting periods without the benefit of hindsight. However, a reporting entity would need to use judgment and consider its specific facts and circumstances before making a determination about the practicability of retrospective application.

### 11.1.4 Other Considerations Related to Parent and Subsidiary Presentation

#### 11.1.4.1 Combined Financial Statements

**ASC 810-10**

45-10 If combined financial statements are prepared for a group of related entities, such as a group of commonly controlled entities, intra-entity transactions and profits or losses shall be eliminated, and noncontrolling interests, foreign operations, different fiscal periods, or income taxes shall be treated in the same manner as in consolidated financial statements.

Consolidated financial statements must be presented when a parent holds a controlling financial interest in its subsidiaries. However, sometimes companies are economically linked because they are under common management or common control (e.g., subsidiaries of a common parent) even though there is no controlling financial interest between the entities under common control. In these circumstances, it may be more appropriate to present combined financial statements if they would be more meaningful to investors than the separate financial statements of the individual entities.

For registrants, only in rare circumstances in connection with an initial filing would combined financial statements be acceptable as the primary financial statements. When companies under common control combine just before or contemporaneously with an initial public offering, it is appropriate to present combined historical financial statements for all periods shown. For additional considerations related to a registrant’s filing of combined financial statements, see Section 1.7.1 of Deloitte’s *A Roadmap to SEC Reporting Considerations for Business Combinations*.

The accounting policies for preparing combined financial statements should be the same as those for preparing consolidated financial statements. For example, in the combined financial statements, any intercompany investment in the combination is offset against the related equity. If there is no
intercompany investment, the individual company equities are combined. Intercompany transactions and profits and losses also should be eliminated.

### 11.1.4.2 Disclosure of Condensed Parent-Company Financial Statements

Paragraph 2810.1 of the SEC Division of Corporation Finance’s Financial Reporting Manual (FRM) requires public companies to disclose condensed parent-company financial statements and to present majority-owned subsidiaries under the equity method when (1) there are restrictions on the ability of subsidiaries to transfer funds to the parent through intercompany loans, advances, or cash dividends and (2) the total of the restricted net assets, when combined with the parent’s equity in the undistributed earnings of investees accounted for under the equity method, exceeds 25 percent of consolidated net assets.

If there are no fund-transfer restrictions, the SEC has also accepted parent-only disclosures outside the basic financial statements (e.g., in MD&A) as long as the disclosures are balanced and not misleading. In addition, the SEC has not objected to the presentation of supplemental consolidating data on the face of the consolidated financial statements. For such presentation, a separate reference to the supplemental consolidating data is not required in the audit report — a footnote on the face of the financial statements describing the data as supplemental is sufficient. Accordingly, no “Supplemental Information” heading is required on the face of the financial statements.

### 11.1.4.3 Stand-Alone Parent-Company Financial Statements

Parent-company financial statements issued on a stand-alone basis do not comply with GAAP. ASC 810-10 states that consolidated financial statements, rather than parent-company financial statements, are the general-purpose financial statements. However, it may be acceptable to issue the parent-company financial statements, as potentially required by paragraph 2810.1 of the FRM, together with the consolidated financial statements if each set of statements clearly indicates that the primary (general purpose) financial statements are the consolidated financial statements.

### 11.1.4.4 Presentation of a Parent Company’s Interest in a VIE When the VIE and Primary Beneficiary of the VIE Are Under Common Control

<table>
<thead>
<tr>
<th>ASC 810-10</th>
</tr>
</thead>
<tbody>
<tr>
<td>30-1 If the primary beneficiary of a variable interest entity (VIE) and the VIE are under common control, the primary beneficiary shall initially measure the assets, liabilities, and noncontrolling interests of the VIE at amounts at which they are carried in the accounts of the reporting entity that controls the VIE (or would be carried if the reporting entity issued financial statements prepared in conformity with generally accepted accounting principles [GAAP]).</td>
</tr>
</tbody>
</table>

In circumstances in which the primary beneficiary of a VIE and the VIE are under common control, the reporting entity should initially measure the assets, liabilities, and noncontrolling interests of the VIE at the amounts at which they are carried in the financial statements of the common parent (i.e., the common parent’s carrying amounts).

For considerations related to reporting a parent’s or affiliate’s interest in the reporting entity’s consolidated subsidiary (i.e., reporting the parent’s or affiliate’s interest in the VIE by the primary-beneficiary subsidiary), see Section 3.1.1 of Deloitte’s *A Roadmap to Accounting for Noncontrolling Interests*. 

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11.1.5 Parent and Subsidiary Accounting Policies

Financial statements are more transparent and relevant if the policies used to account for similar assets, liabilities, operations, and transactions are the same. Therefore, in the absence of justification for differences between them, the accounting policies of a parent and its subsidiaries should be conformed in the parent’s consolidated financial statements.

Only in limited circumstances is it acceptable for the accounting policies of a parent and one or more of its subsidiaries to differ in the parent’s consolidated financial statements. For example, entities may have different accounting policies for inventory, or they may use one method (e.g., LIFO) to measure some inventories and another method (e.g., FIFO or average cost) to measure others. In addition, policies that are transaction-specific could result in the use of different accounting policies for similar items in the consolidated financial statements. For example, the fair value option under ASC 825-10 can generally be elected on an instrument-by-instrument basis.

Entities may, in some cases, be required to apply different accounting policies to comply with industry-specific guidance. ASC 810-10-25-15 states that “[f]or the purposes of consolidating a subsidiary subject to guidance in an industry-specific Topic, an entity shall retain the industry-specific guidance applied by that subsidiary.” This guidance is not intended to result in more than one accounting policy but rather to retain the industry-specific guidance applied by the subsidiary in the consolidated financial statements even if the parent itself or any of its other subsidiaries are not subject to the industry-specific guidance.

When a business is acquired, a parent may wish to change one or more of its accounting policies to conform to the acquiree’s policies. Such a change would represent a voluntary change in accounting principle under ASC 250-10 and would be permitted only if the parent could justify a conclusion that the acquiree’s accounting principle is preferable.

Moreover, the facts and circumstances may support a conclusion that a subsidiary’s accounting policies should be different from its parent’s in the subsidiary’s stand-alone financial statements. For example, a subsidiary may be acquired in a business combination in which pushdown accounting is not applied. The subsidiary would continue to apply the policies it had applied before the acquisition in its stand-alone financial statements, which may differ from the parent’s accounting policies. If the subsidiary wanted to adopt the parent’s policies in its stand-alone financial statements, such a change would represent a voluntary change in accounting principle under ASC 250-10 and would be permitted only if the subsidiary could justify a conclusion that the parent’s accounting principle is preferable.

In addition, a subsidiary may adopt, in its separate financial statements, a new standard in a period other than the period in which the parent adopts it or may use a different transition method for its adoption. In such cases, even though the subsidiary may use different accounting policies in its stand-alone financial statements, the subsidiary’s policies must be conformed to those of the parent in the parent’s consolidated financial statements.

If an adjustment is made to conform the accounting policies of a subsidiary to those of the consolidated group, the entire adjustment should be allocated among the majority and noncontrolling interests. This view is consistent with the underlying assumption that consolidated financial statements represent the financial position and operating results of a single business unit.
11.1.6 Parent-Company Issuance of Stock Compensation to Subsidiary Employees

When a parent company issues stock compensation to a subsidiary’s employees, the subsidiary should record the compensation expense in its separate financial statements. ASC 718-10-15-4 requires the subsidiary to account for the transaction as if it granted the award unless the transfer is “clearly for a purpose other than compensation for services to the reporting entity.” In addition, SAB Topic 1.B (see ASC 220-10-S99-3) requires a subsidiary to recognize in its financial statements expenses incurred by the parent on behalf of the subsidiary.

11.1.7 Allocation of Expenses From a Parent to a Subsidiary — Private Versus Public Subsidiaries

The Codification does not address the allocation of indirect costs incurred by a parent company to a subsidiary in the subsidiary’s stand-alone financial statements. For public companies, SAB Topic 1.B (see in ASC 220-10-S99-3) discusses the allocation of certain direct and indirect costs in financial statements of a subsidiary that are included in a registration statement prepared for the issuance of shares of the subsidiary to the public. In its response to Question 1 of SAB Topic 1.B, the SEC staff states that a registrant (subsidiary) is required to reflect in its historical income statements all costs of doing business, including those incurred by the parent on the subsidiary’s behalf.

Under SAB Topic 1.B, the stand-alone financial statements of a public subsidiary must reflect that subsidiary’s costs incurred by the parent on the subsidiary’s behalf. However, there is no requirement under GAAP for a company with a private subsidiary to allocate to the subsidiary certain indirect expenses incurred by the parent on the subsidiary’s behalf. Nevertheless, the company must consider the disclosure requirements of ASC 850-10-50.

Direct expenses of both public and private subsidiaries that are incurred by the subsidiaries’ parent generally should be reflected in the subsidiaries’ financial statements. For example, if a parent provides inventory to its subsidiary at no charge or directly compensates the subsidiary’s employees, the related costs should generally be reflected in the subsidiary’s financial statements (i.e., be “pushed down” to the subsidiary). Without the push down of these expenses, the subsidiary’s financial statements would be less meaningful because they would not reflect all of the direct costs related to the revenues generated at, and reported by, the subsidiary. Reporting entities will often be required to exercise judgment in determining how to reflect direct expenses and in providing the appropriate disclosures.
11.2 Disclosures for VIEs

ASC 810-10

50-2AA The principal objectives of this Subsection's required disclosures are to provide financial statement users with an understanding of all of the following:

a. The significant judgments and assumptions made by a reporting entity in determining whether it must do any of the following:
   1. Consolidate a variable interest entity (VIE)
   2. Disclose information about its involvement in a VIE.

b. The nature of restrictions on a consolidated VIE's assets and on the settlement of its liabilities reported by a reporting entity in its statement of financial position, including the carrying amounts of such assets and liabilities.

c. The nature of, and changes in, the risks associated with a reporting entity's involvement with the VIE.

d. How a reporting entity's involvement with the VIE affects the reporting entity's financial position, financial performance, and cash flows.

50-2AB A reporting entity shall consider the overall objectives in the preceding paragraph in providing the disclosures required by this Subsection. To achieve those objectives, a reporting entity may need to supplement the disclosures otherwise required by this Subsection, depending on the facts and circumstances surrounding the VIE and a reporting entity's interest in that VIE.

50-2AC The disclosures required by this Subsection may be provided in more than one note to the financial statements, as long as the objectives in paragraph 810-10-50-2AA are met. If the disclosures are provided in more than one note to the financial statements, the reporting entity shall provide a cross reference to the other notes to the financial statements that provide the disclosures prescribed in this Subsection for similar entities.

All reporting entities that have a variable interest in a VIE are subject to the disclosure requirements of ASC 810-10. Reporting entities should consider the overall objectives of ASC 810-10-50-2AA and, depending upon the circumstances, may need to supplement their disclosures to meet these objectives. Meeting these disclosure requirements can sometimes be challenging because a reporting entity might not be privy to all the information about a VIE, especially if the reporting entity is not the primary beneficiary of the VIE but has a variable interest in the VIE and is subject to some of the VIE's disclosure requirements.

The specific VIE disclosure requirements are discussed in the following sections:

- Disclosure requirements for all variable interest holders, including the primary beneficiary — Section 11.2.2.
- Disclosure requirements for only the primary beneficiary — Section 11.2.3.
- Disclosure requirements for only variable interest holders other than the primary beneficiary — Section 11.2.4.
- Disclosure requirements related to certain VIE scope exceptions — Section 11.2.5.
- Other disclosure considerations — Section 11.2.6.
11.2.1 [Deleted]

11.2.2 Disclosure Requirements for All Variable Interest Holders, Including the Primary Beneficiary

<table>
<thead>
<tr>
<th>ASC 810-10</th>
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</thead>
<tbody>
<tr>
<td><strong>50-5A</strong> A reporting entity that is a primary beneficiary of a VIE or a reporting entity that holds a variable interest in a VIE but is not the entity's primary beneficiary shall disclose all of the following:</td>
</tr>
<tr>
<td>a. Its methodology for determining whether the reporting entity is the primary beneficiary of a VIE, including, but not limited to, significant judgments and assumptions made. One way to meet this disclosure requirement would be to provide information about the types of involvements a reporting entity considers significant, supplemented with information about how the significant involvements were considered in determining whether the reporting entity is the primary beneficiary.</td>
</tr>
<tr>
<td>b. If facts and circumstances change such that the conclusion to consolidate a VIE has changed in the most recent financial statements (for example, the VIE was previously consolidated and is not currently consolidated), the primary factors that caused the change and the effect on the reporting entity's financial statements.</td>
</tr>
<tr>
<td>c. Whether the reporting entity has provided financial or other support (explicitly or implicitly) during the periods presented to the VIE that it was not previously contractually required to provide or whether the reporting entity intends to provide that support, including both of the following:</td>
</tr>
<tr>
<td>1. The type and amount of support, including situations in which the reporting entity assisted the VIE in obtaining another type of support</td>
</tr>
<tr>
<td>2. The primary reasons for providing the support.</td>
</tr>
<tr>
<td>d. Qualitative and quantitative information about the reporting entity's involvement (giving consideration to both explicit arrangements and implicit variable interests) with the VIE, including, but not limited to, the nature, purpose, size, and activities of the VIE, including how the VIE is financed. Paragraphs 810-10-25-49 through 25-54 provide guidance on how to determine whether a reporting entity has an implicit variable interest in a VIE.</td>
</tr>
</tbody>
</table>

| **50-5B** A VIE may issue voting equity interests, and the entity that holds a majority voting interest also may be the primary beneficiary of the VIE. If so, and if the VIE meets the definition of a business and the VIE's assets can be used for purposes other than the settlement of the VIE's obligations, the disclosures in the preceding paragraph are not required. |

All variable interest holders, including the primary beneficiary, must provide the above disclosures unless the reporting entity is the primary beneficiary of the VIE and the VIE has all of the following characteristics: (1) it meets the definition of a business, (2) it issues voting equity interests and the primary beneficiary holds a majority voting interest, and (3) its assets can be used other than for the settlement of the VIE's obligations.

**Connecting the Dots**

As discussed in further detail in Section 3.4.4.2, ASU 2017-01 narrowed the definition of a business and consequently reduced the number of legal entities deemed businesses. ASU 2017-01 became effective for public business entities in annual reporting periods beginning after December 15, 2017, including interim periods therein. For all other entities, the ASU is effective in annual reporting periods beginning after December 15, 2018, and interim periods within annual periods beginning after December 15, 2019. Early adoption is permitted for transactions (i.e., acquisitions or dispositions) that occurred before the issuance date or effective date of the ASU if the transactions were not reported in financial statements that have been issued or made available for issuance. The ASU is to be applied prospectively on or after the effective date.
To qualify for the disclosure exemption under characteristic (1) above, a reporting entity that is
the primary beneficiary of a VIE must have determined that any legal entity first consolidated on
or after the ASU’s effective date meets the ASU’s definition of a business. However, we do not
believe that a reporting entity is generally required upon adoption of ASU 2017-01 to reassess
whether a legal entity that previously met the definition of a business continues to meet it.
Therefore, if a reporting entity has not provided the disclosures in ASC 810-10-50-5B because,
in part, the legal entity met the definition of a business at the time of initial consolidation, the
reporting entity can continue to exclude such disclosures regardless of whether the legal
entity would qualify as a business under the amended definition. This view is consistent with
the prospective transition guidance in ASU 2017-01 for transactions occurring on or after
the effective date. Therefore, unless a legal entity is fundamentally redesigned and its entire
purpose has changed (e.g., all of the operations are spun-off and the remaining legal entity
represents a single real estate asset), a reporting entity is not required to reassess whether the
legal entity is a business.

11.2.2.1 Applicability of the Majority Voting Interest Criterion to Limited
Partnerships

For limited partnerships (and similar entities), we believe that in the assessment of the disclosure
exemption criterion in ASC 810-10-50-5B, the general partner’s interest should be considered a “majority
voting interest” if the general partner (1) holds an equity investment that is more than inconsequential
(e.g., 1 percent or more) and (2) has the power to direct the activities of the VIE that most significantly
affect the VIE’s economics through its equity interest, which would generally be the case when there
are no kick-out (or participating) rights held by limited partners. Effectively, when these conditions are
met, the general partner holds 100 percent of the voting class of the limited partnership. If the general
partner meets these conditions, it would be exempt from providing the disclosures in ASC 810-10-50-5A
as long as all the other criteria in ASC 810-10-50-5B are met.

11.2.3 Disclosure Requirements for Only the Primary Beneficiary

<table>
<thead>
<tr>
<th>ASC 810-10</th>
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</table>
| 50-3 The primary beneficiary of a VIE that is a business shall provide the disclosures required by other
guidance. The primary beneficiary of a VIE that is not a business shall disclose the amount of gain or loss
recognized on the initial consolidation of the VIE. In addition to disclosures required elsewhere in this Topic, the
primary beneficiary of a VIE shall disclose all of the following:
| a. Subparagraph superseded by Accounting Standards Update No. 2009-17
| b. Subparagraph superseded by Accounting Standards Update No. 2009-17
| bb. The carrying amounts and classification of the VIE’s assets and liabilities in the statement of financial
position that are consolidated in accordance with the Variable Interest Entities Subsections, including
qualitative information about the relationship(s) between those assets and liabilities. For example, if the
VIE’s assets can be used only to settle obligations of the VIE, the reporting entity shall disclose qualitative
information about the nature of the restrictions on those assets.
| c. Lack of recourse if creditors (or beneficial interest holders) of a consolidated VIE have no recourse to the
general credit of the primary beneficiary
| d. Terms of arrangements, giving consideration to both explicit arrangements and implicit variable
interests that could require the reporting entity to provide financial support (for example, liquidity
arrangements and obligations to purchase assets) to the VIE, including events or circumstances that
could expose the reporting entity to a loss.

A VIE may issue voting equity interests, and the entity that holds a majority voting interest also may be the
primary beneficiary of the VIE. If so, and if the VIE meets the definition of a business and the VIE’s assets can be
used for purposes other than the settlement of the VIE’s obligations, the disclosures in paragraph 810-10-50-
3(bb) through (d) are not required.
A primary beneficiary must provide the above disclosures, in addition to those discussed in Section 11.2.2, unless the VIE has all of the following characteristics: (1) it meets the definition of a business, (2) it issues voting equity interests and the primary beneficiary holds a majority voting interest (see Section 11.2.2.1 for the applicability to limited partnerships), and (3) its assets can be used other than for the settlement of the VIE’s obligations.

Upon initial consolidation, if the VIE meets the definition of a business, the primary beneficiary also should disclose the information required by ASC 805 and any other applicable GAAP. If the VIE does not meet the definition of a business, the primary beneficiary should disclose the amount of gain or loss recognized upon the initial consolidation of the VIE and any other applicable GAAP.

**Connecting the Dots**

See Section 11.2.2 for a discussion of the effects of ASU 2017-01, which changes the definition of a business prospectively.

### 11.2.4 Disclosure Requirements for Only Variable Interest Holders Other Than the Primary Beneficiary

<table>
<thead>
<tr>
<th>ASC 810-10</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>50-4</strong> In addition to disclosures required by other guidance, a reporting entity that holds a variable interest in a VIE, but is not the VIE’s primary beneficiary, shall disclose:</td>
</tr>
<tr>
<td>a. The carrying amounts and classification of the assets and liabilities in the reporting entity’s statement of financial position that relate to the reporting entity’s variable interest in the VIE.</td>
</tr>
<tr>
<td>b. The reporting entity’s maximum exposure to loss as a result of its involvement with the VIE, including how the maximum exposure is determined and the significant sources of the reporting entity’s exposure to the VIE. If the reporting entity’s maximum exposure to loss as a result of its involvement with the VIE cannot be quantified, that fact shall be disclosed.</td>
</tr>
<tr>
<td>c. A tabular comparison of the carrying amounts of the assets and liabilities, as required by (a) above, and the reporting entity’s maximum exposure to loss, as required by (b) above. A reporting entity shall provide qualitative and quantitative information to allow financial statement users to understand the differences between the two amounts. That discussion shall include, but is not limited to, the terms of arrangements, giving consideration to both explicit arrangements and implicit variable interests, that could require the reporting entity to provide financial support (for example, liquidity arrangements and obligations to purchase assets) to the VIE, including events or circumstances that could expose the reporting entity to a loss.</td>
</tr>
<tr>
<td>d. Information about any liquidity arrangements, guarantees, and/or other commitments by third parties that may affect the fair value or risk of the reporting entity’s variable interest in the VIE is encouraged.</td>
</tr>
<tr>
<td>e. If applicable, significant factors considered and judgments made in determining that the power to direct the activities of a VIE that most significantly impact the VIE’s economic performance is shared in accordance with the guidance in paragraph 810-10-25-38D.</td>
</tr>
</tbody>
</table>

In addition to the disclosures discussed in Section 11.2.2, a variable interest holder that is not the primary beneficiary of a VIE must provide the information described above.
11.2.4.1 Maximum Exposure to Loss

ASC 810-10-50-4 requires a reporting entity that has a variable interest in a VIE, but that is not the primary beneficiary of the VIE, to disclose its “maximum exposure to loss as a result of its involvement with the VIE.” A reporting entity’s maximum exposure to loss (both explicit arrangements and implicit variable interests should be considered) includes (1) the amount invested in, and advanced to, the VIE as of the reporting date plus (2) any legal or contractual obligation to provide financing in the future.

A reporting entity’s maximum exposure to loss should include unavoidable future advances of funds or other assets to the VIE, net of the fair value of any goods or services that are received in exchange (e.g., losses related to a firm commitment to purchase future goods from the VIE at above-market rates). This maximum potential loss must be disclosed regardless of the probability that such losses will actually be incurred.

11.2.5 Disclosure Requirements Related to Certain VIE Scope Exceptions

11.2.5.1 Disclosures About the Exhaustive-Efforts Scope Exception

A reporting entity that does not apply the guidance in the Variable Interest Entities Subsections to one or more VIEs or potential VIEs because of the condition described in paragraph 810-10-15-17(c) shall disclose all the following information:

a. The number of legal entities to which the guidance in the Variable Interest Entities Subsections is not being applied and the reason why the information required to apply this guidance is not available
b. The nature, purpose, size (if available), and activities of the legal entities and the nature of the reporting entity’s involvement with the legal entities
c. The reporting entity’s maximum exposure to loss because of its involvement with the legal entities
d. The amount of income, expense, purchases, sales, or other measure of activity between the reporting entity and the legal entities for all periods presented. However, if it is not practicable to present that information for prior periods that are presented in the first set of financial statements for which this requirement applies, the information for those prior periods is not required.

A reporting entity that is not required to apply the VIE guidance because it qualifies for the exhaustive-efforts scope exception (see Section 3.4.3) must apply the above disclosures.

11.2.5.2 Disclosures About Money Market Funds

As discussed in Sections 3.3.4 and 3.3.4.1, a reporting entity that has an interest in certain money market funds should not be evaluated for consolidation under either the voting interest entity model or the VIE model. However, a reporting entity that qualifies for this scope exception is required to disclose any explicit arrangements to provide financial support to the legal entity as well as any instances of such support provided for the periods presented in the performance statement. ASC 810-10-15-12(f)(2) provides the following examples (not all-inclusive) of the types of support that reporting entities should consider:

i. Capital contributions (except pari passu investments)
ii. Standby letters of credit
iii. Guarantees of principal and interest on debt investments held by the legal entity
iv. Agreements to purchase financial assets for amounts greater than fair value (for instance, at amortized cost or par value when the financial assets experience significant credit deterioration)
v. Waivers of fees, including management fees.
11.2.5.3 Disclosure Requirements for Private-Company Alternative

**ASC 810-10**

**Accounting Alternative**

50-2AD A private company lessee that does not apply the requirements of the Variable Interest Entities Subsections to one or more lessor legal entities because it meets the criteria in paragraph 810-10-15-17AB shall disclose the following:

a. The amount and key terms of liabilities (for example, debt, environmental liabilities, and asset retirement obligations) recognized by the lessor legal entity that expose the private company lessee to providing financial support to the legal entity. For example, a private company lessee exposed to debt of the legal entity should disclose information such as the amount of debt, interest rate, maturity, pledged collateral, and guarantees associated with the debt.

b. A qualitative description of circumstances (for example, certain commitments and contingencies) not recognized in the financial statements of the lessor legal entity that expose the private company lessee to providing financial support to the legal entity.

**Pending Content (Transition Guidance: ASC 842-10-65-1)**

50-2AD A private company lessee that does not apply the requirements of the Variable Interest Entities Subsections to one or more lessor legal entities because it meets the criteria in paragraph 810-10-15-17AB shall disclose the following:

a. The amount and key terms of liabilities (for example, debt, environmental liabilities, and asset retirement obligations) recognized by the lessor legal entity that expose the private company lessee to providing financial support to the legal entity. For example, a private company lessee exposed to debt of the legal entity should disclose information such as the amount of debt, interest rate, maturity, pledged collateral, and guarantees associated with the debt.

b. A qualitative description of circumstances (for example, certain commitments and contingencies) not recognized in the financial statements of the lessor legal entity that expose the private company lessee to providing financial support to the legal entity.

**Pending Content (Transition Guidance: ASC 810-10-65-9)**

*Editor’s Note:* Paragraph 810-10-50-2AD will be superseded upon transition, together with its heading:

**Accounting Alternative**

Paragraph superseded by Accounting Standards Update No. 2018-17

50-2AE In applying the disclosure guidance in paragraph 810-10-50-2AD, a private company lessee shall consider exposures through implicit guarantees. The determination as to whether an implicit guarantee exists is based on facts and circumstances. Those facts and circumstances include, but are not limited to, whether:

a. There is an economic incentive for the private company lessee to act as a guarantor or to make funds available.

b. Such actions have happened in similar situations in the past.

c. The private company lessee acting as a guarantor or making funds available would be considered a conflict of interest or illegal.

**Pending Content (Transition Guidance: ASC 810-10-65-9)**

Paragraph superseded by Accounting Standards Update No. 2018-17
ASC 810-10 (continued)

50-2AF In disclosing information about the lessor legal entity, a private company lessee shall present the disclosures in combination with the disclosures required by other guidance (for example, in Topics 460 on guarantees, 850 on related party disclosures, and 840 on leases). Those disclosures could be combined in a single note or by including cross-references within the notes to financial statements.

Pending Content (Transition Guidance: ASC 842-10-65-1)

50-2AF In disclosing information about the lessor legal entity, a private company lessee shall present the disclosures in combination with the disclosures required by other guidance (for example, in Topics 460 on guarantees, 850 on related party disclosures, and 842 on leases). Those disclosures could be combined in a single note or by including cross-references within the notes to financial statements.

Pending Content (Transition Guidance: ASC 810-10-65-9)

Paragraph superseded by Accounting Standards Update No. 2018-17

Accounting Alternative for Entities Under Common Control

Pending Content (Transition Guidance: ASC 810-10-65-9)

50-2AG A reporting entity that neither consolidates nor applies the requirements of the Variable Interest Entities Subsections to a legal entity under common control because it meets the criteria in paragraph 810-10-15-17AD shall disclose the following:

a. The nature and risks associated with a reporting entity's involvement with the legal entity under common control.

b. How a reporting entity's involvement with the legal entity under common control affects the reporting entity's financial position, financial performance, and cash flows.

c. The carrying amounts and classification of the assets and liabilities in the reporting entity's statement of financial position resulting from its involvement with the legal entity under common control.

d. The reporting entity's maximum exposure to loss resulting from its involvement with the legal entity under common control. If the reporting entity's maximum exposure to loss resulting from its involvement with the legal entity under common control cannot be quantified, that fact shall be disclosed.

e. If the reporting entity's maximum exposure to loss (as required by (d)) exceeds the carrying amount of the assets and liabilities as described in (c), qualitative and quantitative information to allow users of financial statements to understand the excess exposure. That information shall include, but is not limited to, the terms of the arrangements, considering both explicit and implicit arrangements, that could require the reporting entity to provide financial support (for example, implicit guarantee to fund losses) to the legal entity under common control, including events or circumstances that could expose the reporting entity to a loss.

50-2AH In applying the disclosure guidance in paragraph 810-10-50-2AG(d) through (e), a reporting entity under common control shall consider exposures through implicit guarantees. Determining whether an implicit guarantee exists is based on facts and circumstances. Those facts and circumstances include, but are not limited to, whether:

a. The private company (reporting entity) has an economic incentive to act as a guarantor or to make funds available.

b. The private company (reporting entity) has acted as a guarantor for or made funds available to the legal entity in the past.
A reporting entity that is not required to apply the VIE guidance because it qualifies for the private-company alternative must provide the disclosures described above, as applicable, depending on whether it has adopted ASU 2018-17. See Section 3.5 for more information about the private-company alternative and ASU 2018-17.

11.2.6 Other Disclosure Considerations

11.2.6.1 Aggregation of Disclosures

A reporting entity should consider both quantitative and qualitative information about the different risks and rewards of each VIE, and the magnitude of those risks and rewards, in determining whether to aggregate disclosures about multiple VIEs. Under either an aggregated or separate presentation, the reporting entity should consider the objectives of ASC 810-10-50-2AA to ensure that disclosures are presented in a manner that clearly explains to financial statement users the nature and extent of the reporting entity's involvement with the VIEs.

When considering whether to aggregate disclosures about multiple VIEs, a reporting entity should assess whether the disclosures are more informative on an aggregated or disaggregated basis from the perspective of a user that is trying to understand the amount and nature of the reporting entity's involvement with the VIE. While disaggregated information may seem to be more useful in most cases, it may sometimes result in excessive and lengthy disclosures.
11.2.6.2  *Interaction With ASC 860 Disclosures*

If a reporting entity (1) securitizes assets under ASC 860 (regardless of whether the securitization achieved sale accounting or is accounted for as a financing or a failed sale) and (2) has a variable interest in, or is the primary beneficiary of, the securitization vehicle, the reporting entity should provide the disclosures required by both ASC 860-10-50 and ASC 810-10-50. This information may be disclosed in more than one note to the financial statements as long as the overall disclosure objectives are met.

11.3  *General Disclosures for Consolidated Subsidiaries*

11.3.1  *Consolidation Policy and Other Disclosures*

**ASC 810-10**

50-1  Consolidated financial statements shall disclose the consolidation policy that is being followed. In most cases this can be made apparent by the headings or other information in the financial statements, but in other cases a note to financial statements is required.

In addition to disclosing the consolidation policy it applies (for both VIEs and voting interest entities), a reporting entity should consider the disclosure requirements in ASC 280-10-50 for any subsidiary that qualifies as a segment of the reporting entity. In accordance with ASC 235-10, companies that have at least one material subsidiary should include a statement such as the following in their accounting policies footnote: “The consolidated financial statements include the accounts of the company and its majority-owned subsidiaries. All intercompany profits, transactions, and balances have been eliminated.”

In addition:

- Whenever a company’s consolidation policy is unusual or complex, or the company changes its policy, it should disclose details about such policy or changes in the policies footnote.

- When some or all of the assets of a subsidiary are not available for the use of the corporate group because of a government regulation, a business restriction, a loan requirement, or otherwise, the details of the restricted assets should be disclosed in a footnote. The assets themselves may need to be separately classified in the consolidated balance sheet to properly reflect the restrictions. Note that ASC 810-10-45-25 requires separate presentation for certain assets and liabilities of a consolidated VIE. See Section 11.1.1 for further discussion.

11.3.2  *Disclosure Requirements for a Parent With a Less Than Wholly Owned Subsidiary*

**ASC 810-10**

50-1A  A parent with one or more less-than-wholly-owned subsidiaries shall disclose all of the following for each reporting period:

a. Separately, on the face of the consolidated financial statements, both of the following:
   1. The amounts of consolidated net income and consolidated comprehensive income
   2. The related amounts of each attributable to the parent and the noncontrolling interest.

b. Either in the notes or on the face of the consolidated income statement, amounts attributable to the parent for any of the following, if reported in the consolidated financial statements:
   1. Income from continuing operations
   2. Discontinued operations
c. Either in the consolidated statement of changes in equity, if presented, or in the notes to consolidated financial statements, a reconciliation at the beginning and the end of the period of the carrying amount of total equity (net assets), equity (net assets) attributable to the parent, and equity (net assets) attributable to the noncontrolling interest. That reconciliation shall separately disclose all of the following:
   1. Net income
   2. Transactions with owners acting in their capacity as owners, showing separately contributions from and distributions to owners
   3. Each component of other comprehensive income.

d. In notes to the consolidated financial statements, a separate schedule that shows the effects of any changes in a parent's ownership interest in a subsidiary on the equity attributable to the parent.

Example 2 (see paragraph 810-10-55-4G) illustrates the application of the guidance in this paragraph.

**Example 2: Presentation and Disclosures Involving Noncontrolling Interests**

55-4G This Example illustrates the application of this Subtopic's presentation and disclosure guidance by a parent with one or more less-than-wholly-owned subsidiaries.

55-4H This Example involves all of the following assumptions:

a. Entity ABC has one subsidiary, Subsidiary A.

b. The tax rate for all years is 40 percent.

c. Entity ABC has 200,000 shares of common stock outstanding and pays dividends of $10,000 each year on those common shares. Entity ABC has no potentially dilutive shares.

d. Subsidiary A has 10,000 shares of common stock outstanding and does not pay dividends.

e. Entity ABC owns all 10,000 shares in Subsidiary A for the entire year 20X1.

f. On June 30, 20X1, Subsidiary A purchases a portfolio of securities for $100,000 and classifies those securities as available for sale.

g. On December 31, 20X1, the carrying amount of the available-for-sale securities is $105,000.

h. For the year ended December 31, 20X1, the amount of Subsidiary A's net income included in the consolidated financial statements is $24,000.

i. On January 1, 20X2, Entity ABC sells 2,000 of its shares in Subsidiary A to an unrelated entity for $50,000 in cash, reducing its ownership interest from 100 percent to 80 percent.

j. Immediately before the January 1, 20X2 sale, Subsidiary A's equity was as follows:

<table>
<thead>
<tr>
<th>Subsidiary A</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Common stock</td>
<td>$ 25,000</td>
</tr>
<tr>
<td>Paid-in capital</td>
<td>50,000</td>
</tr>
<tr>
<td>Retained earnings</td>
<td>125,000</td>
</tr>
<tr>
<td>Accumulated other comprehensive income</td>
<td>5,000</td>
</tr>
<tr>
<td>Total equity</td>
<td>$ 205,000</td>
</tr>
</tbody>
</table>
**ASC 810-10 (continued)**

**k.** The January 1, 20X2 sale of Subsidiary A’s shares by Entity ABC is accounted for as an equity transaction in the consolidated financial statements, as follows:

1. A noncontrolling interest is recognized in the amount of $41,000 ($205,000 × 20 percent).
2. Additional paid-in capital attributable to Entity ABC is increased by $9,000, calculated as the difference between the cash received ($50,000) and the carrying amount of the noncontrolling interest ($41,000).
3. Additional paid-in capital attributable to Entity ABC is also increased by $1,000, which represents the carrying amount of Subsidiary A’s accumulated other comprehensive income related to the ownership interest sold to the noncontrolling interest ($5,000 × 20 percent = $1,000). Accumulated other comprehensive income attributable to Entity ABC is decreased by a corresponding amount.
4. The journal entry to record the sale of Subsidiary A’s shares to the noncontrolling shareholders is as follows:

   | Description                                      | Amount
   |--------------------------------------------------|--------
   | Cash                                             | 50,000 |
   | Accumulated other comprehensive income (Entity ABC) | 1,000  |
   | Noncontrolling interest                          | 41,000 |
   | Additional paid-in capital (Entity ABC)          | 10,000 |

**l.** For the year ended December 31, 20X2, the amount of Subsidiary A’s net income included in the consolidated financial statements is $20,000.

**m.** On January 1, 20X3, Entity ABC purchases 1,000 shares in Subsidiary A from the noncontrolling shareholders (50 percent of the noncontrolling interest) for $30,000 for cash, increasing its ownership interest from 80 percent to 90 percent.

**n.** Immediately before the January 1, 20X3 purchase, the carrying amount of the noncontrolling interest in Subsidiary A was $48,000, which included $4,000 in accumulated other comprehensive income.

**o.** The January 1, 20X3 purchase of shares from the noncontrolling shareholders is accounted for as an equity transaction in the consolidated financial statements, as follows:

1. The noncontrolling interest balance is reduced by $24,000 ($48,000 × 50 percent interest acquired by Entity ABC).
2. Additional paid-in capital of Entity ABC is decreased by $6,000, calculated as the difference between the cash paid ($30,000) and the adjustment to the carrying amount of the noncontrolling interest ($24,000).
3. Additional paid-in capital of Entity ABC is also decreased by $2,000, which represents the carrying amount of Subsidiary A’s accumulated other comprehensive income related to the ownership interest purchased from the noncontrolling shareholders ($4,000 × 50 percent = $2,000).
4. Accumulated comprehensive income attributable to Entity ABC is increased by a corresponding amount ($2,000).
5. The journal entry to record that purchase of Subsidiary A’s shares from the noncontrolling shareholders is as follows:

   | Description                                      | Amount
   |--------------------------------------------------|--------
   | Noncontrolling interest                          | 24,000 |
   | Additional paid-in capital (Entity ABC)          | 8,000  |
   | Accumulated other comprehensive income (Entity ABC) | 2,000  |
   | Cash                                             | 30,000 |

**p.** For the year ended December 31, 20X3, the amount of Subsidiary A’s net income included in the consolidated financial statements is $15,000.
This consolidated statement of financial position illustrates application of the requirement in paragraph 810-10-45-16 that Entity ABC present the noncontrolling interest in the consolidated statement of financial position within equity, but separately from the parent’s equity.

<table>
<thead>
<tr>
<th>Entity ABC</th>
<th>Consolidated Statement of Financial Position</th>
<th>As of December 31</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>20X3</td>
<td>20X2</td>
</tr>
<tr>
<td><strong>Assets:</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Cash</td>
<td>$ 570,000</td>
<td>$ 475,000</td>
</tr>
<tr>
<td>Accounts receivable</td>
<td>125,000</td>
<td>110,000</td>
</tr>
<tr>
<td>Available-for-sale securities</td>
<td>125,000</td>
<td>120,000</td>
</tr>
<tr>
<td>Plant and equipment</td>
<td>220,000</td>
<td>235,000</td>
</tr>
<tr>
<td><strong>Total assets</strong></td>
<td><strong>$1,040,000</strong></td>
<td><strong>$940,000</strong></td>
</tr>
<tr>
<td><strong>Liabilities:</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Total liabilities</strong></td>
<td>$ 555,000</td>
<td>$ 459,000</td>
</tr>
<tr>
<td><strong>Equity:</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Entity ABC shareholders’ equity</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Common stock, $1 par</td>
<td>200,000</td>
<td>200,000</td>
</tr>
<tr>
<td>Paid-in capital</td>
<td>42,000</td>
<td>50,000</td>
</tr>
<tr>
<td>Retained earnings</td>
<td>194,500</td>
<td>167,000</td>
</tr>
<tr>
<td><strong>Accumulated other comprehensive income</strong></td>
<td><strong>22,500</strong></td>
<td><strong>16,000</strong></td>
</tr>
<tr>
<td><strong>Total Entity ABC shareholders’ equity</strong></td>
<td><strong>459,000</strong></td>
<td><strong>433,000</strong></td>
</tr>
<tr>
<td>Noncontrolling interest</td>
<td>26,000</td>
<td>48,000</td>
</tr>
<tr>
<td><strong>Total equity</strong></td>
<td><strong>485,000</strong></td>
<td><strong>481,000</strong></td>
</tr>
<tr>
<td><strong>Total liabilities and equity</strong></td>
<td><strong>$1,040,000</strong></td>
<td><strong>$940,000</strong></td>
</tr>
</tbody>
</table>
This consolidated statement of changes in equity illustrates the requirements in paragraph 810-10-50-1A(c) that Entity ABC present a reconciliation at the beginning and the end of the period of the carrying amount of total equity, equity attributable to Entity ABC, and equity attributable to the noncontrolling interest. It also illustrates that because the noncontrolling interest is part of the equity of the consolidated group, it is presented in the statement of changes in equity.

### Entity ABC

**Consolidated Statement of Changes in Equity**

*Year Ended December 31, 20X3*

<table>
<thead>
<tr>
<th>Entity ABC Shareholders</th>
<th>Total</th>
<th>Retained Earnings</th>
<th>Accumulated Other Comprehensive Income</th>
<th>Common Stock</th>
<th>Paid-In Capital</th>
<th>Noncontrolling Interest</th>
</tr>
</thead>
<tbody>
<tr>
<td>Beginning balance</td>
<td>$ 481,000</td>
<td>$ 167,000</td>
<td>$ 16,000</td>
<td>$ 200,000</td>
<td>$ 50,000</td>
<td>$ 48,000</td>
</tr>
<tr>
<td>Purchase of subsidiary shares from noncontrolling interest</td>
<td>(30,000)</td>
<td>2,000</td>
<td>(8,000)</td>
<td>(24,000)</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Net income (loss)</td>
<td>39,000</td>
<td>37,500</td>
<td></td>
<td>1,500</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Other comprehensive income (loss), net of tax:</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Unrealized gains on securities</td>
<td>5,000</td>
<td>4,500</td>
<td></td>
<td>500</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Other comprehensive income (loss)</td>
<td>5,000</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Dividends paid on common stock</td>
<td>(10,000)</td>
<td>(10,000)</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Ending balance</td>
<td>$ 485,000</td>
<td>$ 194,500</td>
<td>$ 22,500</td>
<td>$ 200,000</td>
<td>$ 42,000</td>
<td>$ 26,000</td>
</tr>
</tbody>
</table>
### Entity ABC

**Consolidated Statement of Changes in Equity**

**Year Ended December 31, 20X2**

<table>
<thead>
<tr>
<th>Entity ABC Shareholders</th>
<th>Total</th>
<th>Retained Earnings</th>
<th>Accumulated Other Comprehensive Income</th>
<th>Common Stock</th>
<th>Paid-In Capital</th>
<th>Noncontrolling Interest</th>
</tr>
</thead>
<tbody>
<tr>
<td>Beginning balance</td>
<td>$ 400,000</td>
<td>$ 155,000</td>
<td>$ 5,000</td>
<td>$ 200,000</td>
<td>$40,000</td>
<td>$ —</td>
</tr>
<tr>
<td>Sale of subsidiary shares to noncontrolling interest</td>
<td>50,000</td>
<td>(1,000)</td>
<td>10,000</td>
<td>41,000</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Net income (loss)</td>
<td>26,000</td>
<td>22,000</td>
<td>4,000</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Other comprehensive income, net of tax:</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Unrealized gains on securities</td>
<td>15,000</td>
<td>12,000</td>
<td>3,000</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Other comprehensive income</td>
<td>15,000</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Dividends paid on common stock</td>
<td>(10,000)</td>
<td>(10,000)</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Ending balance</td>
<td>$ 481,000</td>
<td>$ 167,000</td>
<td>$ 16,000</td>
<td>$ 200,000</td>
<td>$50,000</td>
<td>$ 48,000</td>
</tr>
</tbody>
</table>

See Deloitte’s *A Roadmap to Accounting for Noncontrolling Interests* for detailed, comprehensive guidance on the presentation and disclosure requirements for a parent with a less than wholly owned subsidiary.

### 11.4 SEC Reporting Requirements Upon the Consolidation of a Subsidiary

When an SEC registrant initially consolidates a legal entity (including a VIE or a voting interest entity), the registrant may be required to report the consolidation on Item 2.01 of Form 8-K. The nature of the registrant’s disclosures will depend on whether the consolidated entity (1) represents a business for SEC reporting purposes and (2) is significant. The definition of a business in Regulation S-X, Rule 11-01(d), for SEC reporting purposes differs from the definition of a business in ASC 805-10 for U.S. GAAP accounting purposes. Accordingly, the registrant must perform a separate evaluation under Rule 11-01(d) to determine its SEC reporting requirements. Also, the tests of significance for the consolidation of a legal entity that meets the definition of a business for SEC reporting purposes differs from the tests of significance for an entity that does not meet that definition. In certain circumstances, a registrant may be required to file separate preacquisition historical financial statements for the consolidated entity as well as pro forma financial information for the registrant that gives effect to the consolidation. In addition, the registrant may need to consider internal controls over financial reporting for the consolidated entity (see Section 11.4.3).

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1. It is assumed that registrants have a general understanding of the reporting requirements in SEC Regulation S-X, Rule 3-05 (under which separate preacquisition historical financial statements of the acquired business must be filed when the acquisition of a significant business has occurred or is probable), and Regulation S-X, Article 11 (which establishes the requirements for pro forma financial information). Registrants should also consider the guidance in Topics 2 and 3 of the FRM and Deloitte’s *A Roadmap to SEC Reporting Considerations for Business Combinations*. Registrants may consult with their legal advisers and independent accountants regarding these requirements. In addition, registrants should consider the SEC’s May 2020 final rule that amends the financial statement requirements for acquisitions and dispositions of businesses.
11.4.1 Form 8-K Reporting Obligations

A registrant is required to periodically file current reports on Form 8-K to inform investors of certain events. Under Form 8-K, Item 2.01, the registrant must file a Form 8-K in four business days after a consummated\(^2\) acquisition of (1) a significant amount of assets or (2) a business that is significant. Item 2.01, Instruction 2, defines an acquisition as follows:

The term *acquisition* includes every purchase, acquisition by lease, exchange merger, *consolidation*, succession or other acquisition except that the term does not include the construction or development of property by or for the registrant or its subsidiaries or the acquisition of materials for such purpose. [Emphasis added]

The consolidation of a legal entity, even in circumstances in which the registrant issued no consideration, would therefore be considered an acquisition. Thus, if consolidation occurs when the registrant either (1) becomes initially involved with the legal entity or (2) obtains control in a reporting period after it initially became involved with the legal entity (e.g., a reconsideration event as described in Chapter 9), the registrant must consider the requirements of Item 2.01. See the highlights of the March 2015 CAQ SEC Regulations Committee joint meeting with the SEC staff.

As noted above, a registrant's filing requirements vary on the basis of whether the consolidated entity (1) represents a business for SEC reporting purposes and (2) is significant. See Section 11.4.1.3 for a discussion of the definition of a business for SEC reporting purposes.

Item 2.01, Instruction 4, discusses significance and states:

An acquisition or disposition shall be deemed to involve a significant amount of assets:

(i) if the registrant's and its other subsidiaries' equity in the net book value of such assets or the amount paid or received for the assets upon such acquisition or disposition exceeded 10% of the total assets of the registrant and its consolidated subsidiaries; or

(ii) if it involved a business (see 17 CFR 210.11-01(d)) that is significant (see 17 CFR 210.11-01(b)).

A registrant is required to file its initial Form 8-K within four business days after the completion of an acquisition. For a reconsideration event that results in consolidation, the registrant is generally required to file the initial Form 8-K within four business days after occurrence of the reconsideration event. However, the filing may be delayed if the registrant does not identify the reconsideration event until the interim or annual financial reporting closing process. A registrant should consult with legal counsel if it believes that it can use, as an alternative, the date it files financial statements reflecting the consolidation. See the highlights of the June 2009 and September 2009 CAQ SEC Regulations Committee joint meetings with the SEC staff.

See the discussions of Form 8-K reporting requirements under Item 2.01 for the consolidation of entities that, for SEC reporting purposes, are not a business (Section 11.4.1.2) and are a business (Section 11.4.1.3).

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\(^2\) A Form 8-K may also be required under Item 1.01 when a registrant has entered into a material definitive agreement for an acquisition (e.g., when it executes a contract to acquire a significant amount of assets or a significant business). An Item 1.01 Form 8-K is generally filed earlier than an Item 2.01 Form 8-K, which is not required until the acquisition is consummated. Since Item 2.01 triggers a requirement to provide financial statements in accordance with Item 9.01, such financial statements are not required in the Item 1.01 Form 8-K. Registrants may wish to consult with their legal advisers regarding these requirements.
11.4.1.1 Definition of a Business for SEC Reporting Purposes

The definition of a business in Regulation S-X, Rule 11-01(d), for SEC reporting purposes is not the same as that in ASC 805-10. A registrant must carefully evaluate the requirements in Rule 11-01(d) to determine whether a consolidated entity is a business for SEC reporting purposes. See paragraph 2010.1 of the FRM for additional guidance. For more information about determining whether a consolidated entity is a business for SEC reporting purposes, see Section 1.3.1 of Deloitte’s *A Roadmap to SEC Reporting Considerations for Business Combinations*.

11.4.1.2 Consolidated Entity Is Not a Business for SEC Reporting Purposes

If the consolidated entity does not meet the definition of a business for SEC reporting purposes, the consolidation should be regarded as an asset acquisition and reported under Form 8-K, Item 2.01, if it exceeds the 10 percent threshold specified in the two significance tests in Instruction 4. These tests are similar to the asset and investment tests in Regulation S-X, Rule 1-02(w).

Since Regulation S-X, Rule 3-05, does not apply, no historical financial statements need to be filed for this type of acquisition. However, the disclosures in Item 2.01 should clearly (1) describe the assets acquired, (2) describe the anticipated effects on the registrant’s financial condition, and (3) indicate that the acquisition did not constitute the consolidation of a business. A registrant may also consider disclosing limited pro forma balance sheet information reflecting the effects of the asset acquisition (or, e.g., a narrative discussion if adjustments are easily understood) if such information would be material to investors.

As noted in Section 11.4.1, an initial Form 8-K must be filed four business days after an acquisition or, for a reconsideration event that results in consolidation, within four business days after its occurrence. If material, the pro forma balance sheet information described above must be included in the initial Form 8-K. The 71-calendar-day extension in Form 8-K, Item 9.01, that is available for a consolidated entity that is a business is not available to a consolidated entity that is not a business.

11.4.1.3 Consolidated Entity Is a Business for SEC Reporting Purposes

If the consolidated entity meets the definition of a business for SEC reporting purposes, the registrant should use Form 8-K, Item 2.01, to report the consolidation if it is significant. As noted in Instruction 4 of Item 2.01, a business is significant if any of the results of the three significance tests in SEC Regulation S-X, Rule 1-02(w) (i.e., the asset, income, and investment tests), exceed 20 percent.

To comply with Item 2.01, the registrant must apply SEC Regulation S-X, Rule 3-05, which generally requires the filing of separate preacquisition historical audited financial statements for the significant consolidated entity or business acquired. The financial statement periods required to be filed will be based on the highest significance level determined after performance of any of the three tests in Rule 1-02(w). Unaudited historical financial statements as of and for the appropriate interim periods preceding the consolidation may also be required. In addition, the registrant must provide pro forma financial information in accordance with Article 11 to reflect the consolidation (see Section 11.4.1.4).

As noted in Section 11.4.1, an initial Form 8-K must be filed four business days after an acquisition or, for a reconsideration event that results in consolidation, within four business days after its occurrence. If available, the historical and pro forma financial statements may be filed along with the initial Form 8-K. Otherwise, the registrant has an additional 71 calendar days to file an amended Form 8-K that includes both of these historical and pro forma financial statements.
11.4.1.4 Pro Forma Financial Information Under Article 11

Article 11 lists several circumstances in which a registrant may be required to provide pro forma financial information, including when an acquisition of a significant business has occurred or is probable. Since the consolidation of a legal entity that meets the definition of a business for SEC reporting purposes would be considered an acquisition, a registrant may need to provide pro forma financial information when it (1) initially becomes involved with the legal entity or (2) obtains control in a reporting period after initially becoming involved with the legal entity (e.g., a reconsideration event, as described in Chapter 9). Pro forma financial information for the appropriate periods may be required in a registration statement, proxy statement, or Form 8-K. For additional SEC interpretive guidance on Article 11, see Topic 3 of the FRM and Chapter 3 of Deloitte’s A Roadmap to SEC Reporting Considerations for Business Combinations.

See Section 11.4.1.2 for a discussion of the pro forma requirements when a registrant consolidates an entity that does not meet the definition of a business for SEC reporting purposes.

11.4.2 Rule 3-13 Waivers and Other Requests

The SEC staff encourages registrants to seek modifications to their financial reporting requirements under Regulation S-X, Rule 3-13, particularly when the requirements are burdensome but may not be material to the total mix of information available to investors. An example of such a modification includes, but is not limited to, the omission of one or more years of historical financial statements for a recently consolidated business subject to Rule 3-05.

While a registrant may be granted relief from providing Rule 3-05 financial statements and complying with related pro forma requirements, the registrant must still file Item 2.01 of Form 8-K before consolidating a subsidiary. A waiver under Rule 3-13 applies only to historical and pro forma financial statement requirements and does not provide relief from filing Item 2.01 of Form 8-K. See Section 11.4.1 for more information. For additional guidance on Rule 3-13 waivers and other requests, see Appendix B of Deloitte’s A Roadmap to SEC Comment Letter Considerations, Including Industry Insights.

For additional information about SEC comments related to consolidation, see Section 2.2 of Deloitte’s A Roadmap to SEC Comment Letter Considerations, Including Industry Insights.

11.4.3 ICFR Considerations for a Consolidated Entity in the Year of Initial Consolidation

In the year after a registrant consolidates a legal entity (including a VIE or a voting interest entity), it may be appropriate for management to exclude that entity from consideration when it performs its assessment of internal control over financial reporting (ICFR). While Question 3 in the SEC staff’s Management’s Report on Internal Control Over Financial Reporting and Certification of Disclosure in Exchange Act Periodic Reports — Frequently Asked Questions applies to a material acquisition of a business, the highlights of the March 2015 CAQ SEC Regulations Committee joint meeting with the SEC staff note the SEC staff’s view that registrants may “analogize to this FAQ under appropriate facts and circumstances.” When determining whether to exclude an entity from the ICFR assessment, registrants should consider the period between the consolidation date and the date of management’s assessment. Registrants are also encouraged to discuss their specific facts and circumstances with the SEC staff.

See paragraphs 3220.1, 3230.1, and 3230.2 of the FRM and Section 3.3.1.2 of Deloitte’s A Roadmap to SEC Reporting Considerations for Business Combinations for guidance on the appropriate periods to present pro forma financial information. In addition, registrants should consider the SEC’s May 2020 final rule that amends the pro forma financial information requirements for acquisitions and dispositions of businesses.
Appendix A — [Deleted]
Appendix B — [Deleted]
Appendix C — Expected Losses and Expected Residual Returns

Under FIN 46(R), the primary beneficiary of a VIE was determined on the basis of the reporting entity that absorbed the majority of the legal entity’s expected losses, received the majority of the entity’s expected residual returns, or both. As a result, reporting entities were often required to perform a quantitative calculation of expected losses and expected residual returns. However, with each subsequent revision in ASU 2009-17 and ASU 2015-02 to the VIE consolidation guidance, the FASB reduced the emphasis on this quantitative analysis of expected losses and expected residual returns. Consequently, the evaluation of the characteristics of the primary beneficiary of a VIE has changed from focusing on a quantitative analysis of expected losses and expected residual returns to performing a qualitative analysis of whether the reporting entity has both control over the activities that most significantly affect the VIE’s economic performance and a variable interest that could potentially be significant to the returns or losses of the VIE (see further discussion in Section 7.3).

C.1 The Need to Calculate Expected Losses and Expected Residual Returns

The VIE model generally does not require entities to use the quantitative approach described in the definitions of the terms “expected losses,” “expected residual returns,” and “expected variability”; rather, for all aspects of a VIE consolidation analysis, a qualitative assessment of the relevant facts and circumstances is generally sufficient. Nevertheless, to perform a VIE consolidation analysis, the reporting entity should understand the relevant concepts underlying the quantitative approach described in the definitions of those terms, including those related to the following:

- The definition of a variable interest (see Section 2.14).
- The definition of subordinated financial support (see Section 2.13).
- The assessment of whether a decision-maker fee is a variable interest. To determine whether a fee paid to a decision maker or service provider is a variable interest, a reporting entity may need to perform, as part of its evaluation under ASC 810-10-55-37(c), a quantitative calculation of expected losses and expected residual returns of a legal entity. See Section 4.4.
- The identification of silos and variable interests in specified assets (see Chapter 6 and Section 4.3.11).
- The determination of whether a legal entity is a VIE. In making such a determination, a reporting entity may need to calculate the legal entity’s expected losses to evaluate whether the legal entity’s equity at risk is sufficient to absorb expected losses (if a qualitative assessment under ASC 810-10-15-14(a) was not conclusive). See Section 5.2.
- The reconsideration of whether a legal entity is a VIE (see Chapter 9).
The determination of which party, within a related-party group under common control or a group of related parties that share power, is the primary beneficiary of a VIE. In making this determination, a reporting entity may need to calculate the expected losses and residual returns of a legal entity to evaluate each party's exposure to the variability associated with the anticipated economic performance of the VIE under ASC 810-10-25-44(c). See Section 7.4.2.4.

C.2 Definitions of Expected Losses and Expected Residual Returns

**ASC 810-10 — Glossary**

**Expected Losses**
A legal entity that has no history of net losses and expects to continue to be profitable in the foreseeable future can be a variable interest entity (VIE). A legal entity that expects to be profitable will have expected losses. A VIE's expected losses are the expected negative variability in the fair value of its net assets exclusive of variable interests and not the anticipated amount or variability of the net income or loss.

**Expected Losses and Expected Residual Returns**
Expected losses and expected residual returns refer to amounts derived from expected cash flows as described in FASB Concepts Statement No. 7, *Using Cash Flow Information and Present Value in Accounting Measurements*. However, expected losses and expected residual returns refer to amounts discounted and otherwise adjusted for market factors and assumptions rather than to undiscounted cash flow estimates. The definitions of expected losses and expected residual returns specify which amounts are to be considered in determining expected losses and expected residual returns of a variable interest entity (VIE).

**Expected Residual Returns**
A variable interest entity's (VIE's) expected residual returns are the expected positive variability in the fair value of its net assets exclusive of variable interests.

**Expected Variability**
Expected variability is the sum of the absolute values of the expected residual return and the expected loss. Expected variability in the fair value of net assets includes expected variability resulting from the operating results of the legal entity.

The terms “expected losses” and “expected residual returns” refer to amounts derived from the calculation of “expected cash flows of a VIE.” This calculation is based broadly on the techniques for developing cash flow estimates under the expected cash flow approach in Concepts Statement 7. However, although both Concepts Statement 7 and the VIE model prescribe a cash flow scenario technique and require discounting of cash flows, calculations of expected cash flows under the two are not the same.

To apply the expected cash flow approach in Concepts Statement 7, a reporting entity must calculate expected values to develop estimated cash flow scenarios. In general — as with any traditional expected value calculation — a “pure” (unadjusted) Concepts Statement 7 calculation would include, for each scenario, all cash flows into and out of the VIE, regardless of the source of those cash flows.

To apply the cash flow scenario technique under the VIE model, a reporting entity must include the cash flows stemming from sources of variability in, and exclude cash flows stemming from variable interests from, the cash flows that it would otherwise use in the calculation of the expected value of the VIE under Concepts Statement 7. For example, cash flow amounts representing distributions that stem from variable interests are not included as cash outflows of the VIE in the determination of the VIE's expected

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1 A “scenario” is a single cash flow outcome that is developed on the basis of the potential variability in the economic performance of a legal entity, exclusive of cash flows received from or distributed to the variable interests in the legal entity. Multiple cash flow scenarios are determined and probability-weighted in the calculation of the aggregate expected losses and aggregate expected residual returns of a legal entity. See Section C.3 for further discussion of the number of cash flow scenarios used in calculating the expected losses and expected residual returns of a legal entity.
losses or expected residual returns. Similarly, cash flow amounts that represent receipts stemming from variable interests are not considered cash inflows to the VIE. By excluding those amounts, the VIE model's calculation of expected cash flows attempts to isolate changes (variability) in the fair value of the VIE's existing net assets that are creators of variability. The objective of the expected cash flows calculation under the VIE model is for the reporting entity to arrive at a single estimate of the amount resulting from the probability-weighted, discounted cash flows generated by the VIE that variable interest holders are expected to ultimately receive (as returns) or absorb (as losses) from the VIE.

As with all expected value calculations, the final product (expected cash flows of the VIE) is a mean or average value associated with a group of possible probability-weighted outcomes. In calculating that mean or average, a reporting entity should develop a number of cash flow scenarios to reflect different possible outcomes. Some cash flow scenarios will represent outcomes that are lower than the mean amount, and some will represent outcomes higher than the mean amount. Each outcome reflects a variance from the mean — those that are lower than the mean represent negative variability (these are “expected loss” scenarios), and those that are higher than the mean represent positive variability (those are the “expected residual return” scenarios). The actual calculation of expected losses and expected residual returns requires that the outcome under each scenario be subtracted from the mean. The “expected losses of the VIE” are equal to the sum of the differences from the mean of all of the expected loss scenarios, while the “expected residual returns of the VIE” are equal to the sum of the differences from the mean of all of the expected residual return scenarios. Because there are many possible outcomes for each legal entity (i.e., many cash flow scenarios), each legal entity will have expected losses and expected residual returns.

The calculation of expected cash flows under Concepts Statement 7 or the VIE guidance is not equivalent to the amounts that are reported in a cash flow statement prepared under GAAP. In addition, the expected losses and expected residual returns of the VIE do not represent actual gains or losses of the VIE. Those calculations represent the variability from the VIE's mean cash flows. For example, if the expected cash flows of a VIE are calculated at $800,000 (this is the average of all scenarios), an amount of $40,000 would be included in the expected losses of the VIE for a single scenario that results in cash flows of $760,000. Note that although this is considered an expected loss, the actual outcome for the VIE under that scenario is a positive cash flow of $760,000. See Section C.3 for further guidance on calculating the expected cash flows of a potential VIE. In addition, ASC 810-10-55-42 through 55-54 illustrate the calculation of variability for both expected losses and expected residual returns.

C.2.1 Meaning of “Net Assets” in the Definitions of Expected Losses and Expected Residual Returns

The definitions of “expected losses” and “expected residual returns” contain references to the fair value of the “net assets exclusive of variable interests.” The term “net assets exclusive of variable interests” does not refer to the net assets as identified on a legal entity's balance sheet under GAAP. Under the VIE model, the term “net assets exclusive of variable interests” represents the sources of variability in the entity. That is, the objective of the net asset calculation is to include only the estimated cash flows stemming from assets, liabilities, contracts, or other relationships that do not represent variable interests. Net assets under the VIE model differ from those described elsewhere in GAAP (i.e., the excess of assets over liabilities). For example, net assets under the VIE model may include unrecognized firm commitments, contractual arrangements with service providers or decision makers, or supply contracts that are not recorded under GAAP. Conversely, a derivative under GAAP that is deemed a variable interest would not be part of the net assets exclusive of variable interests, as used in the calculations.

In addition, for expected losses and expected residual returns, net assets are exclusive of (1) variable interests and (2) interests in specific assets (as described in ASC 810-10-25-55 and 25-56). Note that
this treatment has the same effect as excluding the variability in the asset (or portion of the asset) and excluding the interest in that asset.

C.3 How to Calculate Expected Losses and Expected Residual Returns

As discussed in Section C.2, a reporting entity determines expected losses and expected residual returns by calculating the “expected cash flows of the entity” under the VIE model. To determine the expected cash flows of the legal entity under the VIE model, a reporting entity must develop a number of estimated cash flow scenarios, each with its own cash flow result. Concepts Statement 7 is useful for developing estimated cash flow scenarios under the VIE model. However, estimated cash flow scenarios under the VIE model exclude certain cash inflows and outflows that occur between the legal entity and its variable interest holders, which would be included in a traditional calculation of expected cash flows under Concepts Statement 7.

Once the cash flow scenarios are developed, they are probability-weighted and summed to arrive at the expected cash flows of the legal entity under the VIE model. By comparing that amount to each outcome in each estimated cash flow scenario, a reporting entity can identify positive variability (expected residual return scenarios) and negative variability (expected loss scenarios). Finally, the reporting entity discounts the expected loss and expected residual return scenarios and totals each set of scenarios to determine the expected losses (the sum of the discounted cash flow scenarios giving rise to negative variability) and the expected residual returns (the sum of the discounted cash flow scenarios giving rise to positive variability) of the legal entity.

The following steps outline an approach to determining the expected losses and expected residual returns of the legal entity under the VIE model:

- **Step 1** — Distinguish the sources of variability from the variable interests in the legal entity.
- **Step 2** — Develop the scenarios of estimated cash flows attributable to the sources of variability under the VIE model.
- **Step 3** — Calculate the expected cash flows of the legal entity under the VIE model.
- **Step 4** — Calculate the expected variability (i.e., expected losses and expected residual returns) in expected cash flows for each scenario.

The paragraphs below provide guidance on applying these steps.

C.3.1 Step 1 — Distinguish the Sources of Variability From the Variable Interests in the Legal Entity

Each of the legal entity’s assets, liabilities, contracts, and equity items represents either a source of variability or variable interests in the legal entity. The first step in calculating the expected cash flows of the legal entity (and, consequently, the expected losses and expected residual returns) is to distinguish the variable interests and the legal entity’s assets, liabilities, equity, and other contractual arrangements that represent sources (or creators) of variability. This step is important for a number of reasons.

First, unless otherwise exempt from the provisions of the VIE model, each holder of a variable interest in the legal entity is subject to the disclosure requirements in ASC 810-10. Conversely, a reporting entity that does not hold a variable interest (either directly or indirectly through its related parties or de facto agents) cannot be the primary beneficiary of a VIE and is not subject to the disclosure requirements. Second, a reporting entity does not include cash flows to or from variable interests as cash outflows or inflows of the legal entity in developing cash flow scenarios. Consequently, it is important to distinguish sources of variability from variable interests to ensure that the calculation of the legal entity’s expected
cash flows appropriately represents the amount of cash flows that would be expected to be allocated to variable interest holders.

Recall from Section C.1 that the determination of whether a legal entity is a VIE is sometimes based, in part, on the calculation of expected losses, which is expected negative variability from the amount identified as the legal entity's expected cash flows, and the calculation of expected residual returns, which represents positive variability from the amount identified as the legal entity's expected cash flows. Under the VIE model, the basis for the distinction between the legal entity's asset, liability, contract, and equity items that are variable interests and those that are not is that interests that create positive or negative variability are not variable interests and those that receive positive or absorb negative variability are variable interests. (For further guidance on determining whether an interest is a variable interest in an entity, see Chapter 4.) In other words, if the returns of the legal entity are less than expected (negative variability or expected losses), an item that is a variable interest typically would receive a lower return than expected, thus “absorbing” expected losses. Conversely, if the returns of the legal entity are more than expected, an item that is a variable interest would typically receive a return that is greater than expected, thus “receiving” expected residual returns. Any item that either absorbs expected losses or receives expected residual returns is considered a variable interest in the legal entity.

Once the variable interests have been distinguished from the sources of variability, a reporting entity must further evaluate the variable interests. Under ASC 810-10-25-55 and 25-56, a reporting entity treats some interests in specified assets that otherwise would be considered variable interests as sources of variability in deriving the expected cash flows of the legal entity under the VIE model (see Section 4.3.11).

C.3.2 Step 2 — Develop the Scenarios of Estimated Cash Flows Attributable to Sources of Variability Under the VIE Model

In step 2, the reporting entity must develop various (non-probability-weighted) scenarios, each of which estimates the legal entity's cash flows from sources of variability under different assumptions about future conditions and circumstances. Each scenario will represent an estimate of one possible future cash flow outcome of the net assets, exclusive of variable interests in the legal entity, and will incorporate different expectations and uncertainties about the amount or timing of those cash flows. Concepts Statement 7 states that “present value should attempt to capture the elements that taken together would comprise a market price if one existed.” Thus, the assumptions that management uses to develop the legal entity's estimated cash flow scenarios should be those that marketplace participants would use and should not be based solely on management's own perspective.

As a result of considering the legal entity's “cash drivers” (i.e., key factors that affect the cash flows associated with the legal entity's assets and liabilities), management will develop differing expectations about cash flows for each scenario. Cash drivers can vary from entity to entity and include such factors as credit risk, price risk, interest rate risk, currency risk, technological innovation and obsolescence, competition, supply and demand for products and services, and general economic conditions. Management must use judgment in developing market-based assumptions about changes in cash drivers and their effects on the timing and amount of estimated cash flows and should document its conclusions and the basis for those conclusions.

Management should develop cash flow scenarios on the basis of all the possible variations in the operating results of the legal entity. The cash flow scenarios must incorporate a reasonable period. At the end of the forecast period, the cash flows should reflect the outcome of all assets being sold at fair market value with the proceeds used to settle all liabilities that are not variable interests (e.g., trade payables and accrued expenses that are not variable interests). In other words, each cash flow scenario
must incorporate a terminal value into its cash flow estimate if the life of the legal entity could extend beyond a period subject to reasonable estimation.

A reporting entity may develop its scenarios by starting with either GAAP net income or cash flows or by using other methods to develop the cash flow amounts. Starting with cash flows will be easier than starting with net income because, as part of calculating the legal entity's expected losses and expected residual returns, a reporting entity must calculate an amount for the expected cash flows of the legal entity by using an approach based on the techniques in Concepts Statement 7 for calculating expected present value. However, if GAAP-based projections are used, the cash inflows and outflows must be adjusted to reverse the cash inflows and outflows related to items identified as variable interests. That is, the cash flows incorporated into the scenarios used to develop the legal entity's expected cash flows do not incorporate cash inflows or outflows that stem from a variable interest (identified in step 1). The result of each scenario should represent the estimated cash flows to be absorbed or received by the collective variable interest holders if that scenario were to occur.

C.3.3 Step 3 — Calculate the Expected Cash Flows of the Legal Entity Under the VIE Model

Whereas each scenario provides a single estimate of an amount to be paid or received in the future, the VIE model's expected cash flows of the legal entity is the sum of the probability-weighted outcomes of those scenarios. Thus, each scenario outcome identified in step 2 must be probability-weighted (in a manner consistent with the approach to calculating expected cash flows under Concepts Statement 7). A reporting entity assigns probabilities on the basis of the likelihood of occurrence of that scenario in relation to all scenarios. The selection of probabilities should be based on all facts and circumstances and requires judgment (the sum of the probabilities assigned to the scenarios must equal 100 percent). The sum of the estimated (probability-weighted) cash flows for all scenarios is equal to the expected cash flows of the legal entity under the VIE model.

C.3.4 Step 4 — Calculate the Expected Variability (i.e., Expected Losses and Expected Residual Returns) in the VIE Model's Expected Cash Flows for Each Scenario

A reporting entity determines expected losses and expected residual returns under the VIE model by first using the risk-free rate to discount the outcomes under each relevant scenario and then summing the discounted amounts. The mean of the discounted amounts can be calculated from the sum; the results of the calculations for all the scenarios can be compared against this mean. The sum of the discounted amounts is the expected cash flows to be received/absorbed by the variable interest holders. ASC 810-10-55-42 through 55-49 refer to this amount as “fair value.” Under certain circumstances, one important check of the reasonableness of the calculation of discounted expected cash flows is a comparison of the result to the fair value of all the variable interests. Under ASC 820-10-20, fair value is “[t]he price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date.”

The scenarios giving rise to negative variability result in expected losses, and the scenarios giving rise to positive variability result in expected residual returns. For each scenario, the reporting entity calculates the expected variability in the expected cash flows under the VIE model by subtracting the discounted expected cash flows of the legal entity from the discounted estimated cash flows and multiplying the difference by the relevant probability. When the result of that calculation is positive (i.e., estimated cash flows associated with a scenario are greater than the expected cash flows of the entity), the result is positive variability, indicating that the scenario is an expected residual return scenario. When the cash flows associated with a scenario are less than the expected cash flows, the result is negative variability,
indicating that the scenario is an expected loss scenario. The sum of the negative variability scenarios is the expected losses of the legal entity. The sum of the positive variability scenarios is the expected residual returns of the entity.

### C.3.5 Decision-Maker and Service-Provider Fees (Step 1)

The treatment of decision-maker and service-provider fees depends on whether the fees have to be treated as a variable interest (see Section 4.4). If it is determined that decision-maker and service-provider fees are variable interests, the fees would be excluded from the expected losses/residual returns calculation (i.e., excluded from the VIE’s cash flows). Accordingly, the amount determined to be expected losses would be allocated to the variable interest holders, including decision makers and service providers deemed to hold a variable interest. If it is determined that decision-maker and service-provider fees are not variable interests, the fees would be included in the expected losses/residual returns calculation (i.e., included in the VIE’s cash flows).

### C.3.6 Options or Guarantees on Specific Assets (Step 1)

A legal entity may write an option to purchase an asset of the entity (a call option written by the entity) or purchase a residual value guarantee on an asset of the entity (a put option purchased by the entity). In these or similar situations, questions may arise regarding whether the cash flows associated with the option should be included in the calculation of expected losses and expected residual returns.

The determination of whether the option (or guarantee) is included in the cash flows used to calculate expected losses and expected residual returns depends on whether the option (or guarantee) is determined to be a variable interest in the legal entity under ASC 810-10-25-55 and 25-56. If the fair value of the asset is less than 50 percent of the total fair value of the legal entity’s assets and the option (or guarantee) is not considered an interest in a “silo” pursuant to ASC 810-10-25-57, the option (or guarantee) on the asset would not be considered a variable interest in the legal entity; therefore, the cash flows associated with the option (or guarantee) should be included in the calculation of expected losses and expected residual returns of the legal entity. However, if the option (or guarantee) is a variable interest in the legal entity (or in a “silo”), in all scenarios, the cash flows associated with the option (or guarantee) should not be included in the calculation of expected losses and expected residual returns of the legal entity.

### C.3.7 Low-Income Housing or Similar Tax Credits (Step 1)

Expected cash flow scenarios developed for calculating expected losses and expected residual returns generally should not include the effect of the variable interest holder’s income taxes (i.e., the income tax effect on the variable interest holder). However, the income tax effect should not be confused with the estimated income taxes to be paid by the potential VIE. This amount should be considered, because the legal entity’s payment of income taxes affects the amount of cash flows available to the variable interest holders.

Occasionally, the economics of the legal entity and the fair value of a variable interest necessitate consideration of the effects of noncash tax credits that may be passed through the legal entity to variable interest holders. In such cases, the incremental cash flow equivalent from income tax credits should be included in the expected cash flow calculation at its fair value. For example, by design, a reporting entity may invest in a legal entity that receives tax incentives in the form of tax credits (e.g., affordable housing projects, or projects that produce energy or fuel from alternative sources) to receive a pass-through of the tax benefits. Regardless of whether the tax benefits will be used by the legal entity or the investors in the legal entity, because the tax benefits affect the fair value of the legal entity and the amount that an investor would be willing to pay for an interest in the legal entity, a reporting entity
should include these tax benefits in the expected cash flows at fair value when calculating expected losses and expected residual returns. At the 2004 AICPA Conference on Current SEC and PCAOB Developments, the SEC staff supported this position, stating:

In another situation involving activities around the entity, investors became involved with an entity because of the availability of tax credits generated from the entity's business. Through an arrangement around the entity, the majority of the tax credits were likely to be available to one specific investor. Accordingly, the staff objected to an analysis by this investor that 1) did not include the tax credits as a component of the investor's variable interest in the entity and 2) did not consider the impact of the tax credits and other activities around the entity on the expected loss and expected residual return analysis.

C.3.8 Developing Estimated Cash Flow Scenarios and Assigning Probabilities (Steps 2 and 3)

As indicated above, to calculate expected losses and expected residual returns, a reporting entity must develop estimated cash flow scenarios. There is no set number of scenarios that a reporting entity must develop in calculating expected losses and expected residual returns. However, the number of scenarios should be sufficient for the expected cash flows of the legal entity under the VIE model, discounted at the risk-free rate, to approximate the fair value of the legal entity's net assets, exclusive of variable interests (also to approximate the fair value of the legal entity's variable interests), as of the determination date. (For guidance on using a market risk premium to calculate expected losses and expected residual returns, see Section C.3.11.)

When developing the inputs used to calculate expected losses and expected residual returns, management must use judgment to determine the number of scenarios and assign probabilities. For complex entities or entities with a large number of dissimilar assets and liabilities affected by various risk factors, a reporting entity may need to develop and aggregate cash flow estimates for individual asset or liability groups or for categories of risks to arrive at an appropriate estimate of the cash flows in any given scenario.

Note that it may be helpful for a reporting entity to use a Monte Carlo simulation approach, or another similar approach, in calculating expected losses and expected residual returns. Under this approach, a reporting entity considers thousands of scenarios on the basis of primary factors that affect the cash flows and variability of the legal entity. Such an approach may be especially useful if there are multiple drivers of expected losses in the legal entity.

Management should keep in mind the following guidelines regarding the number of cash flow estimates/scenarios:

• The best-case scenario and worst-case scenario provide upper and lower boundaries on the estimated cash flows.
• The sum of the probabilities associated with each scenario must equal 100 percent.
• The most likely scenario (if there is one) will have the highest probability relative to the others.

In addition, a reporting entity should consider the following in developing scenarios and assigning probabilities (this list is not all-inclusive):

• The scenarios should reflect the effects of possible changes in key drivers of cash flows (e.g., interest rate risk, credit risk, risk of changes in market prices of assets, supply and demand for products, technological innovation and obsolescence) on the legal entity's asset values that can result in variations in expected losses and expected residual returns. A scenario that does not address assumptions about the critical cash flow drivers should be viewed with skepticism.
• Scenarios should not include changes to the design of a legal entity’s business that are not required by existing governing documents and contractual arrangements. For example, scenarios used for a legal entity that is designed to hold and operate a manufacturing facility with installed machinery should not include a change, whether planned or unplanned, to remove the machinery and convert the building into a rental property, unless that change is specified in the legal entity’s governing documents or contractual arrangements.

• Scenarios should, however, include changes within the design of the legal entity’s business that are a source of the legal entity’s variability. For example, assume that a legal entity is designed to hold investment securities that it plans to actively manage within defined parameters, resulting in changes in the mix of securities held. For that legal entity, scenarios should include the cash flow effects of potential acquisitions and dispositions of securities within the defined parameters. It is not appropriate to include scenarios that only reflect a static pool of securities for such a legal entity.

• In general, the more scenarios that are developed, the more precise the analysis of the variability that each holder absorbs in the legal entity will be.

• The calculations of the legal entity’s expected losses and expected residual returns include those associated with variable interests in the legal entity. Some variable interest holders may hold interests in specified assets of the legal entity that are not considered variable interests in the entity. For more information, see ASC 810-10-25-55 and 25-56 and Section C.3.6.

• When discounted at the risk-free rate, the sum of probability-weighted cash flows from all scenarios should generally approximate the fair value of the legal entity’s net assets exclusive of variable interests, as well as the fair value of the legal entity’s variable interests as of the determination date. For guidance on using a market risk premium to calculate expected losses and expected residual returns, see Section C.3.11.

• Management of a reporting entity should be able to justify the assignment of a probability to a particular scenario. Market-based assumptions are used to develop probabilities. Market participants’ perspectives on the ability to realize asset values and related cash flows may differ from management’s perspective for various reasons, such as management’s possession of information that is not available to market participants or management’s intent to use an asset in a different or innovative way that is not incorporated into the assumptions used by market participants (paragraphs 25–38 of Concepts Statement 7 contain additional discussion). For the expected loss and residual return calculation, management should develop probabilities from the perspective of market participants and the information that would be available to them.

• Concepts Statement 7 provides general guidance on developing estimates of cash flows for expected present value calculations. ASC 820-10 defines fair value and establishes a framework for measuring it. Although ASC 820-10 did not amend Concepts Statement 7, it clarifies Concepts Statement 7’s guidance on determining fair value.

Note that, as discussed above, the calculation of expected cash flows under the VIE model in ASC 810-10 is not exactly the same as that under Concepts Statement 7.
C.3.9 Inclusion of Noncash Receipts or Distributions in the Estimated Cash Flow Scenarios (Step 2)

In one or more of the scenarios considered in the development of a legal entity's estimated cash flows, a variable interest holder could contribute to, or receive from, the legal entity noncash assets (e.g., real estate, other tangible assets, or investments). When developing a legal entity's estimated cash flow scenarios for the calculation of expected losses or expected residual returns, the receipt or distribution of assets other than cash should be treated as if a receipt or distribution (respectively) of cash equal to the fair value of the assets was received or distributed. For example, if a variable interest holder has agreed to provide assets other than cash to settle its obligations to the legal entity or if the legal entity is required to settle an obligation to a variable interest holder with noncash assets, those receipts or distributions of noncash assets must be considered receipts from, or distributions to, variable interests holders on the same basis as a cash receipt or distribution. As noted in Section C.2, cash outflows stemming from variable interests are not included as cash outflows of the legal entity in the determination of the legal entity's expected losses or expected residual returns. Similarly, cash flows that represent receipts from holders of variable interests are not considered cash inflows to the legal entity.

For example, assume that BigLessor holds all of the equity in SpecialLeaseCo, an entity established solely to finance the purchase of property that is then leased under an operating lease with LesseeCo, an unrelated third party. The lease term is 20 years. At the end of the lease term, SpecialLeaseCo will dissolve and title to the property will be distributed to BigLessor. In the calculation of the entity's estimated cash flows under this scenario, the property (an asset of the entity) would be considered a source (or creator) of variability. Thus, each scenario would include an amount equal to the estimated fair value of the property as part of the entity's cash flows (a positive cash flow to the entity that is available under that estimated scenario for distribution to a holder of a variable interest in the entity) at the end of the 20-year lease term.

C.3.10 Discount Rate to Use in Calculating Expected Losses and Expected Residual Returns (Step 4)

The risk-free rate should be applied to the individual, probability-weighted cash flows in each scenario developed for calculating expected losses and expected residual returns. Regarding the expected cash flow approach to computing present value, paragraph 40 of Concepts Statement 7 states that only the time value of money is included in the discount rate because other risk factors that cause adjustments to the cash flows are reflected in the cash flow estimates in each of the scenarios and the probabilities associated with them. For U.S. entities, the risk-free interest rate is the rate currently available on zero-coupon U.S. government issues. Thus, for each cash flow scenario, a reporting entity should use the implied yield currently available on zero-coupon U.S. government issues, with a remaining term equal to the term associated with the cash flows being valued. For example, the five-year zero-coupon U.S. government rate should be used for cash flows projected five years from the date the cash flow analysis began (see the discussion of the cash flow and fair value approaches in Section C.4).

This approach is different from traditional present value techniques, in which a single scenario is developed (in many cases, the contractual cash flows or the most probable cash flows). Under such approaches, the scenario is discounted by a rate that incorporates risks (e.g., a 12 percent discount rate is used to adjust for risks that are not considered in the single scenario). The risk-free rate is appropriate under the VIE model calculation in ASC 810-10 because, similarly to the Concepts Statement 7 approach, the VIE model in ASC 810-10 requires a probability-weighted cash flow approach that incorporates these risks into the various scenarios, as opposed to adjusting for risks in its discount rate. If a rate higher than the risk-free rate is used, a reporting entity would understate the variability in cash flows in accordance with the calculation of expected losses and expected residual returns required by the VIE model. See
also Section C.3.11, which discusses the impact of ASC 820-10 on an expected loss/residual return calculation.

C.3.11 Impact of ASC 820-10 on the Calculation of Expected Losses and Expected Residual Returns (Step 4)

ASC 810-10-20 states that expected losses and expected residual returns “refer to amounts [derived from expected cash flows] discounted and otherwise adjusted for market factors and assumptions rather than to undiscounted cash flow estimates.” Recall that ASC 820-10 defines fair value and establishes a framework for measuring it, and that although ASC 820-10 did not amend Concepts Statement 7, it clarifies Concepts Statement 7’s guidance on determining fair value.

ASC 820-10-55-13 through 55-20 discuss a risk premium in the context of an expected present value calculation used to determine fair value. The risk premium is an adjustment to an expected present value calculation to convert the expected cash flows to certainty-equivalent cash flows. That is, the effect of the adjustment results in an indifference to trading a certain cash flow for an expected cash flow. ASC 820-10 describes two methods of adjusting an expected present value technique used to calculate fair value for a risk premium. In the first method, the expected cash flows are adjusted by subtracting out a cash risk premium; in the second method, the risk premium is a percentage adjustment to the risk-free interest rate.

Although ASC 820-10 is not intended to amend the provisions of the VIE model, reporting entities should be mindful of a market risk premium in developing an expected loss calculation. ASC 810-10-55-42 through 55-49 refer to the sum of the discounted probability-weighted amounts for each scenario under the expected present value technique as fair value. Therefore, ASC 820-10’s guidance should be considered in the calculation of expected losses and expected residual returns under the VIE model. In practice, determining adjustments for such risk premiums may require considerable judgment.

As an alternative to including an adjustment for a risk premium in the expected loss/residual return calculation, a reporting entity may consider the risk premium as one method of checking the overall reasonableness of the cash flows used in the expected loss/residual return calculation by comparing the total of the probability-weighted discounted cash flows with the fair value of the net assets of the VIE, exclusive of its variable interests. When performing this reasonableness check, a reporting entity may discover a difference between the transacted or known fair value and the probability-weighted discounted cash flows. This difference may partially or entirely represent the risk premium described above.

When evaluating the reasonableness of an expected loss calculation under the VIE model, a reporting entity should understand the potential causes of this difference, including the portion that can reasonably be attributed to the risk premium. Errors in the calculation should not be attributed to the effect of the risk premium. Because the primary drivers of the risk inherent in the VIE’s operations are reflected in the probability weighting of the different scenario’s projected cash flows, the risk premium adjustment should generally be smaller relative to the expected cash flows or risk-free interest rate. In addition, when the risk-free rate is adjusted, the resulting interest rate will probably be lower than the risk-adjusted rate used in the discount rate adjustment technique. Note that the discount rate adjustment technique (described in ASC 820-10-55-10 through 55-12) uses a single set of cash flows from the range of possible outcomes. The discount rate used is derived from observed rates of return for comparable assets and liabilities traded in the market.
C.4 Cash Flow and Fair Value Approaches to Calculating Expected Losses and Expected Residual Returns

Two approaches may be used to calculate expected losses and expected residual returns: the cash flow approach and the fair value approach. Under each, a reporting entity should develop multiple cash flow scenarios that result from all potential outcomes. There are no differences in these gross projected cash flows under either the cash flow or fair value approach. The differences, as described below, arise only from the discount rates applied to each of the cash flow scenarios.

C.4.1 Cash Flow Approach

The underlying principle of the cash flow approach is that a legal entity’s variability arises from fluctuations in its cash flows. Under the cash flow method, changes in future interest rates are not anticipated. In an expected loss/residual return calculation, the only variations in the risk-free rates used are within each cash flow scenario and reflect the time value of money for varying periods.

Example C-1

Assume that Entity X (a U.S. legal entity) is created with cash contributions from various equity investors and that its governing documents state that its life is five years. Assume that there are three cash flow scenarios for X’s expected loss/residual return calculation. At inception, the zero-coupon bond rates for U.S. Treasury bonds maturing between one and five years are 5.0 percent, 5.15 percent, 5.25 percent, 5.5 percent, and 5.75 percent, respectively. Under the cash flow approach, the first year of cash flows in each of the three scenarios would be discounted at 5.0 percent, the second year’s cash flows at 5.15 percent, and so forth. The discount rates applied to the various scenarios do not anticipate increases or decreases in future interest rates. In other words, a static yield curve is used.

C.4.2 Fair Value Approach

The underlying principle of the fair value approach is that the source of a legal entity’s variability is fluctuations in the fair value of the legal entity’s net assets. In contrast to the cash flow approach, the fair value approach of calculating expected losses and residual returns incorporates anticipated changes in interest rates into each cash flow scenario. In other words, multiple yield curves are used to reflect the different interest rate environments the legal entity may encounter. The different yield curves used under the fair value approach should be consistent with the assumptions used in the related scenario. Consequently, in the calculation of expected losses under the fair value approach, the discount rates applied in each of the three scenarios would incorporate the changes in interest rates that Entity X in Example C-1 above may encounter and should be consistent with the assumptions used in each of the three scenarios. Therefore, in contrast to the cash flow method, the discount rate applied to the first year of cash flows may be different in each of the three scenarios to reflect an anticipated increase or decrease in interest rates (and not a single yield curve).
C.4.3 Appropriateness of the Cash Flow Approach or Fair Value Approach to Calculating Expected Losses and Expected Residual Returns

ASC 810-10-25-21 through 25-36 provide guidance on determining whether an interest in a legal entity is a variable interest. Those paragraphs discuss the "by-design" approach to determining which variability to consider in the evaluation of whether an interest is a variable interest. A reporting entity that holds a variable interest in a VIE should consider the guidance in ASC 810-10-25-21 through 25-36 in determining the variability that a legal entity is designed to create and pass along to its interest holders and, in light of its determination, whether to use the cash flow method or fair value method to calculate expected losses and expected residual returns.

In many instances, the legal entity may be designed to create and pass along cash flow variability to its variable interest holders. Therefore, in such cases, it would be appropriate for a reporting entity to use a cash flow approach. However, a legal entity may be designed primarily to pass along fair value variability, in which case it would be appropriate to apply the fair value approach. Although ASC 810-10-25-21 through 25-36 do not provide specific guidance on when either of these methods should be used to calculate expected losses and residual returns, ASC 810-10-55-55 through 55-86 give examples of when using these methods would be appropriate.

Case D in ASC 810-10-55-68 through 55-70 describes a legal entity that is designed to create and pass along fair value variability attributable to changes in interest rates. In this example, the legal entity holds fixed-rate assets and floating-rate debt (no interest rate swap is used); therefore, an interest rate mismatch exists. The interest rate mismatch was designed to expose the debt investors to changes in the fair value of the investments. Therefore, Case D concludes that a reporting entity must consider interest rate risk associated with changes in the fair value of fixed-rate periodic interest payments received. In this example, it is reasonable to use a fair value method of calculating expected losses and residual returns.

If a reporting entity is applying different approaches to different VIEs, it should ensure that (1) different methods are not used for VIEs that have similar structures and (2) there is a reasonable basis supporting the use of different methods given the reporting entity's specific facts and circumstances.

C.4.4 Using the Cash Flow Approach or Fair Value Approach to Determine Whether Fees Paid to Decision Makers or Service Providers Are Variable Interests

ASC 810-10-55-37 lists conditions that must be met for a reporting entity to determine that fees paid to a decision maker or a service provider do not represent a variable interest. To meet the condition in ASC 810-10-55-37(c), the decision maker or service provider cannot hold other variable interests in the legal entity that individually, or in the aggregate, absorb more than an insignificant amount of the legal entity's expected losses or receive more than an insignificant amount of the legal entity's expected residual returns. In determining whether this condition is met, in accordance with ASC 810-10-55-37, a decision maker or service provider should consider its direct economic interests in the legal entity (other than the fee arrangement) together with its indirect economic interests in the legal entity held through related parties.

ASC 810 does not specify any particular approach that a reporting entity should use to determine whether the condition in ASC 810-10-55-37(c) is met. A decision maker or service provider will generally be able to perform a qualitative analysis to determine whether the condition in ASC 810-10-55-37(c) is met. As indicated in ASC 810-10-55-37D, a quantitative analysis typically would not be needed. However, if a reporting entity determines that such analysis is necessary, the decision maker or service provider generally should apply a variation of the "top-down" allocation method (described below) to all legal entities evaluated.
Before ASU 2009-17’s amendments to the VIE model, there were two fundamental allocation methods for identifying the primary beneficiary of a VIE: the top-down method and the “bottoms-up” method. These methods were based on the allocation of expected losses and expected residual returns to the variable interests. Several variations of the top-down method were developed in practice. Under each method, a reporting entity must use the contractual cash inflow and outflow provisions between the legal entity and the variable interest holders in allocating expected losses and expected residual returns to the variable interests. The top-down and bottoms-up methods and their variations are summarized below.

<table>
<thead>
<tr>
<th>Method</th>
<th>Comments</th>
</tr>
</thead>
<tbody>
<tr>
<td>Top-down</td>
<td>The top-down method has many variations. Fundamentally, however, each variable interest holder calculates its expected losses and expected residual returns on the basis of the cash flows that would be allocated to it under each scenario. That is, the cash flows that are used to calculate the aggregate expected losses and aggregate expected residual returns of the legal entity are allocated to each variable interest holder on the basis of the contractual provisions of its interests and the underlying assumptions used for each scenario. In practice, variations in applying the top-down method are due to how the expected losses and expected residual returns are assigned to each variable interest holder when one party absorbs an expected loss while another receives an expected residual return in a single cash flow scenario. Although there may be more than one acceptable approach to applying the top-down method when expected losses and expected residual returns are allocated to multiple variable interest holders under a single cash flow scenario (i.e., one party absorbs an expected loss and another party receives an expected residual return in a single cash flow scenario), under any potential approach the total amount of the expected losses and expected residual returns allocated to each variable interest holder must equal the aggregate expected losses and aggregate expected residual returns of the legal entity.</td>
</tr>
<tr>
<td>Bottoms-up</td>
<td>Under the bottoms-up method, the aggregate expected losses (and aggregate expected residual returns, if necessary) of the legal entity are treated as a single cash flow scenario that is assumed to occur. That amount of expected losses and expected residual returns is allocated to each variable interest holder on the basis of the calculated fair value of each variable interest holder (i.e., the probability-weighted discounted expected cash flows) in the legal entity, starting with the most subordinate variable interest to the most senior variable interest. The bottoms-up method is limited by the fact that it does not take into account the timing or causes of the expected losses and expected residual returns of the legal entity when those amounts are allocated to the variable interest holders. Therefore, the bottoms-up method is not operational when different variable interest holders have different rights (obligations) regarding the receipt (absorption) of different risks that cause the variability of the legal entity or when the timing of the occurrence of the risks that the legal entity was designed to pass on to the variable interest holders has a significant impact on the overall variability of the legal entity that will be absorbed by the variable interest holders.</td>
</tr>
</tbody>
</table>

Although the calculation of expected losses and expected residual returns is not prevalent under the VIE model, the top-down method may be appropriate in the assessment of the condition in ASC 810-10-55-37(c) if a reporting entity determines that a quantitative analysis is necessary for such evaluation. When a quantitative analysis is deemed necessary, a decision maker or service provider can select any reasonable top-down method of allocating a legal entity's expected losses and expected residual returns to the variable interest holders. However, because the application of different variations of the top-down method could result in different conclusions under ASC 810-10-55-37(c), the reporting entity should apply a consistent variation of the method to all legal entities for which a quantitative analysis of ASC 810-10-55-37(c) is deemed necessary.
Because it is assumed under the bottoms-up method that only the aggregate expected losses and aggregate expected residual returns of the VIE will occur, this approach is appropriate only when (1) there is a single type of risk that is designed to be passed on to the variable interest holders or (2) the subordination of classes of variable interests to other variable interests is the same for all types of risks designed to be passed on to the variable interest holders, regardless of the timing of when those risks are absorbed by the variable interest holders. That is, no matter what type of risk causes the legal entity's loss or the timing of that loss, the loss must be absorbed in the ascending order of the various classes of variable interests' priority claims.2 Because neither of the conditions necessary for application of the bottoms-up method typically exist for decision-making or servicing contracts (because (1) a decision maker or service contract generally will not absorb all the elements of the variability of a legal entity, (2) the timing of the variability will affect the absorption, or (3) both), the bottoms-up method is generally not appropriate when a quantitative analysis is deemed necessary to the evaluation of the condition in ASC 810-10-55-37(c).

C.5 Example of a Calculation of Expected Losses and Expected Residual Returns

Below is an example of a calculation of expected losses and expected residual returns. As noted in Section C.1, a reporting entity is generally not required to calculate expected losses and expected residual returns in performing a consolidation analysis under the VIE model. However, in this example, it is assumed that the reporting entity did not qualify for an exception to the VIE subsections of ASC 810-10 and that because a qualitative assessment under ASC 810-10-15-14(a) was inconclusive, the reporting entity calculated expected losses and expected residual returns in evaluating whether the legal entity is a VIE.

Assume that a legal entity (PowerCo) is created to hold a power plant with a fair value of $10 million at inception. PowerCo is funded by unrelated investors as follows:

- Contributions by two unrelated investors of $1 million each for an equity investment at risk.
- The issuance to a single investor of $5 million in senior fixed-rate bonds, due in 25 years in a lump-sum (“bullet maturity”) payment, with a 5 percent interest rate.
- The issuance to a single investor of $3 million in subordinated fixed-rate bonds, due in 25 years in a bullet maturity payment, with a 7.5 percent interest rate.

Further assume the following:

- PowerCo uses $9.95 million of the proceeds from equity contributions and debt to purchase a power plant. The other $50,000 of proceeds is used to pay a guarantee premium on the subordinated bond as discussed below.
- As a condition of lending, the subordinated debt holder requires PowerCo to obtain a credit guarantee, which will cover any shortfall of the subordinated debt principal payment up to $1 million. PowerCo pays a third-party guarantor a premium of $50,000 for the guarantee.
- PowerCo enters into a forward contract to sell its output at market value to an unrelated third party but retains a significant amount of the operating risk associated with the power plant.
- An unrelated party, ManageCo, runs the plant and makes all of the significant operating decisions. ManageCo has a five-year contract and receives a fixed fee of $90,000 per year, plus an additional 1 percent of net income before this fee, impairment expense, depreciation expense, and guarantor premiums or proceeds.

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2 The aggregate expected losses of a legal entity result from the probability weighting of numerous possible scenarios that could occur. The cause of each potential loss scenario is not known under the bottoms-up method because the expected losses of the legal entity that are being allocated are treated as a single “hypothetical” scenario that is assumed to occur.
C.5.1 Performing Step 1

Under step 1 of the calculation, a reporting entity must identify variable interests in the legal entity (see Section C.3.1). The interests in PowerCo are analyzed below.

<table>
<thead>
<tr>
<th>Interest</th>
<th>Description</th>
</tr>
</thead>
<tbody>
<tr>
<td>Equity</td>
<td>PowerCo's equity does not create losses or residual returns; rather, the equity is the most subordinated interest in PowerCo and therefore absorbs losses (negative variability) first. If returns of PowerCo are greater than expected, it will receive returns (positive variability) that are greater than those provided to more senior interests (i.e., the senior bond holder and the subordinated bond holder). Thus, the equity interests are variable interests.</td>
</tr>
<tr>
<td>Subordinated bond</td>
<td>The subordinated bond does not create losses or residual returns; rather, it is a variable interest in PowerCo because it is subordinated to the senior bond and, therefore, would have to absorb losses (after the equity) if PowerCo does not generate enough cash to pay interest or principal on the bond.</td>
</tr>
<tr>
<td>Senior bond</td>
<td>The analysis is the same as that for the subordinated bond above (i.e., the senior bond is a variable interest in PowerCo). Although the equity and subordinated bond absorb PowerCo's expected losses first, scenarios are possible in which returns are less than expected and for which the senior bond also will absorb losses.</td>
</tr>
<tr>
<td>Subordinated bond guarantee</td>
<td>The subordinated bond guarantee is a variable interest in PowerCo because it must absorb losses if PowerCo does not generate enough cash to pay interest or principal on the subordinated bond (see ASC 810-10-55-25). Although the guarantee gives rise to future cash flows of the entity, those cash flows are triggered by, and are intended to make up for, returns that are less than expected.</td>
</tr>
<tr>
<td>Power plant</td>
<td>The power plant is the primary asset that will be used to generate cash flows from PowerCo's operations. These operations create the variability in PowerCo that will be absorbed by the variable interest holders. The power plant is not a variable interest.</td>
</tr>
<tr>
<td>Third-party customers</td>
<td>The design of PowerCo is important to the determination of whether the third-party customer holds a variable interest in PowerCo. According to ASC 810-10-25-35, the determination of whether a forward contract to sell electricity is a variable interest is based, in part, on whether (1) its &quot;underlying is an observable market rate, price, index of prices or rates, or other market observable variable&quot; and (2) the &quot;counterparty is senior in priority relative to other interest holders in the legal entity.&quot; In addition, if changes in the cash flows or fair value of the forward contract are expected to offset all, or essentially all, of the electricity price risk and operating risk related to the power plant, further analysis of the design of PowerCo would be required. Criteria (1) and (2) above are met in this instance, and although PowerCo sells the electricity at market value, it still retains a significant amount of operations risk associated with the power plant; therefore, the forward contract is considered a creator of variability and is not a variable interest. This conclusion would change if the forward contract was designed to reimburse PowerCo for all or essentially all of the costs related to operating the power plant. (See Section E.5 for further discussion of analyzing PPAs and tolling arrangements.)</td>
</tr>
<tr>
<td>ManageCo contract</td>
<td>ASC 810-10-55-37 provides guidance on whether a fee paid to a decision maker is a variable interest. In this example, it is assumed that the ManageCo contract is a variable interest.</td>
</tr>
</tbody>
</table>
On the basis of the above analysis, the estimated cash flows from the operations of the power plant (including the sales to third parties) and the estimated changes in the fair value of the power plant not reflected in net income or loss (i.e., terminal value at the end of the plant's useful life) represent the assets and contracts that create the variability in PowerCo. The equity, senior bond, subordinated bond, subordinated bond guarantee, and ManageCo contract represent the variable interests in PowerCo. Even if one of the variable interest holders qualified for an exception to the VIE model, each variable interest is still treated as an absorber of variability in the calculation of expected losses and expected residual returns.

### C.5.2 Performing Step 2

Under step 2 of the calculation, a reporting entity must develop the scenarios of estimated cash flows attributable to sources of variability under the VIE model (see Section C.3.2).

As noted in Section C.3.8, cash flow scenarios are developed on the basis of all of the possible variations in the operating results of PowerCo. PowerCo uses the “indirect method” to calculate the estimated cash flows for each scenario (i.e., it starts with GAAP net income and makes adjustments to arrive at the expected cash flows for each scenario such that the expected cash flows only include the cash flows created by PowerCo that are absorbed by the variable interest holders). In this case, PowerCo only considers cash flows related to the operations of the plant and the terminal value of the plant. PowerCo starts its calculation with amounts derived under GAAP and adjusts those amounts to exclude the impact on GAAP amounts of cash flows related to the variable interests (i.e., any cash inflow or outflow stemming from the equity, debt, the guarantee, or the management contract).

For simplicity, only three possible scenarios are contemplated in this example — best case (Scenario 1), most likely case (Scenario 2), and worst case (Scenario 3). In practice, a reporting entity may need to consider more scenarios (see Section C.3.8). In addition, it is assumed for simplicity that the cash flows of PowerCo have been estimated over a five-year period. In practice, a reporting entity must use judgment to determine the appropriate period over which cash flows reasonably can be estimated. At the end of the five-year period, the power plant is assumed to be sold at fair value under each scenario, and the proceeds from the sale are incorporated into the estimated cash flow scenarios. For each scenario, it is assumed that the power plant is depreciated over 20 years. Table C-1 shows the results for all three scenarios:

<table>
<thead>
<tr>
<th>Table C-1 — Undiscounted Cash Flows</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Undiscounted Cash Flows to Be Received</strong></td>
</tr>
<tr>
<td>From or Paid to the Entity by Sources of Variability</td>
</tr>
<tr>
<td>Scenario 1</td>
</tr>
<tr>
<td>Scenario 2</td>
</tr>
<tr>
<td>Scenario 3</td>
</tr>
</tbody>
</table>

### C.5.3 Performing Step 3

Under step 3 of the calculation, a reporting entity must calculate the expected cash flows of the legal entity under the VIE model (see Section C.3.3).
To determine the expected cash flows of the entity under the VIE model, the reporting entity must weigh the probability of each cash flow outcome associated with each of the three scenarios (this approach is consistent with the approach to calculating expected cash flows under Concepts Statement 7). Probabilities are assigned on the basis of the likelihood of the occurrence of that scenario compared with that of all other scenarios. The selection of probabilities should be based on all facts and circumstances (the sum of the probabilities assigned to the scenarios must equal 100 percent). Table C-2 shows the calculation of the expected cash flows of PowerCo under the VIE model.

### Table C-2 — Undiscounted Expected Cash Flows

<table>
<thead>
<tr>
<th>PowerCo</th>
<th>Undiscounted Estimated Cash Flows (A)</th>
<th>Probability (B)</th>
<th>Probability-Weighted Undiscounted Expected Cash Flows (A × B)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Scenario 1</td>
<td>$15,450,000</td>
<td>25%</td>
<td>$3,862,500</td>
</tr>
<tr>
<td>Scenario 2</td>
<td>13,220,000</td>
<td>50</td>
<td>6,610,000</td>
</tr>
<tr>
<td>Scenario 3</td>
<td>8,714,400</td>
<td>25</td>
<td>2,178,600</td>
</tr>
<tr>
<td>Undiscounted</td>
<td></td>
<td></td>
<td>$12,651,100</td>
</tr>
<tr>
<td>expected cash</td>
<td>flows under the VIE model in ASC 810-10</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Flows under the VIE model in ASC 810-10</td>
<td>100%</td>
<td>$12,651,100</td>
<td></td>
</tr>
</tbody>
</table>

### C.5.4 Performing Step 4

Under step 4 of the calculation, a reporting entity must calculate the expected variability (i.e., expected losses and expected residual returns) in expected cash flows for each scenario (see Section C.3.4).

Expected losses and expected residual returns are determined by first using the risk-free rate to discount the outcomes under each relevant scenario and then summing the discounted amounts. The mean of the discounted amounts can be calculated from the sum; the results of the calculations for all three scenarios can be compared against this mean. Table C-3 illustrates the calculation of the discounted expected cash flows for the three scenarios:

### Table C-3 — Discounted Expected Cash Flows

<table>
<thead>
<tr>
<th>PowerCo</th>
<th>Discounted Estimated Cash Flows (A)*</th>
<th>Probability (B)</th>
<th>Probability-Weighted Discounted Expected Cash Flows (A × B)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Scenario 1</td>
<td>$12,735,519</td>
<td>25%</td>
<td>$3,183,880</td>
</tr>
<tr>
<td>Scenario 2</td>
<td>10,902,195</td>
<td>50</td>
<td>5,451,098</td>
</tr>
<tr>
<td>Scenario 3</td>
<td>7,134,616</td>
<td>25</td>
<td>1,783,654</td>
</tr>
<tr>
<td>Undiscounted</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>expected cash</td>
<td>flows under the VIE model in ASC 810-10</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Flows under the VIE model in ASC 810-10</td>
<td>100%</td>
<td>$10,418,632</td>
<td></td>
</tr>
</tbody>
</table>

* Table C-4 illustrates the calculation of discounted estimated cash flows for Scenario 3.
### Table C-4 — Undiscounted Cash Flows (Scenario 3)

<table>
<thead>
<tr>
<th>Sources of Variability</th>
<th>Year 1</th>
<th>Year 2</th>
<th>Year 3</th>
<th>Year 4</th>
<th>Year 5</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash flows to be</td>
<td>$785,000</td>
<td>$755,000</td>
<td>$720,000</td>
<td>$588,000</td>
<td>$5,866,400</td>
<td>$8,714,400</td>
</tr>
<tr>
<td>received from or paid</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>to the entity by</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>sources of variability</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Discount rate*</td>
<td>5%</td>
<td>5%</td>
<td>5%</td>
<td>5%</td>
<td>5%</td>
<td>5%</td>
</tr>
<tr>
<td>Discounted cash flows</td>
<td>$747,619</td>
<td>$684,807</td>
<td>$621,963</td>
<td>$483,749</td>
<td>$4,596,478</td>
<td>$7,134,616</td>
</tr>
</tbody>
</table>

* The discount rate used was held constant at 5 percent for all years for simplicity. However, a reporting enterprise should use the implied yield currently available on zero-coupon U.S. government issues with a remaining term equal to the term associated with the cash flows being valued (see Section C.3.10 for further discussion of discount rate). The same forward interest rate curve should be used for each scenario. That is, one of the variables in each scenario cannot be a fluctuation in the discount rate (i.e., use of a different yield curve).

In Table C-3, the discounted expected cash flows were calculated to be $10,418,632. ASC 810-10-55-44 and 55-45 refer to this amount as “fair value.” Under certain circumstances, the fair value of all the variable interests is one measure of the reasonableness of the calculation of discounted expected cash flows. In this example, fair value is assumed to be the sum of what the variable interest holders paid or contributed for their interests. The approximate fair value of the variable interests is as follows:

### Table C-5 — Fair Value of the Variable Interests

<table>
<thead>
<tr>
<th>Variable Interest Holder</th>
<th>Fair Value</th>
</tr>
</thead>
<tbody>
<tr>
<td>Equity holders</td>
<td>$2,000,000</td>
</tr>
<tr>
<td>Senior bond holder</td>
<td>5,000,000</td>
</tr>
<tr>
<td>Subordinated bond holder</td>
<td>3,000,000</td>
</tr>
<tr>
<td>Third-party guarantor</td>
<td>— *</td>
</tr>
<tr>
<td>Decision maker</td>
<td>417,048 **</td>
</tr>
<tr>
<td>Total fair value</td>
<td>$10,417,048</td>
</tr>
</tbody>
</table>

* The third-party guarantor has a fair value of zero because the entity gave up value of $50,000 in the form of a premium for a promise to pay in the future. The discounted probability-weighted cash flows are ($50,000) for honoring the guarantee.

** The decision maker has a fair value based on its discounted probability-weighted fees to be received from the VIE.

Because the discounted expected cash flows of $10,418,632 approximate the fair value of the variable interests in the entity of $10,417,048, the underlying assumptions used in developing the estimated cash flows appear to be appropriate. A reporting entity can compare the discounted expected cash flows of each variable interest with its fair value at inception to determine whether the assumptions and probabilities used appear proper. The next step in determining the expected losses and expected residual returns is to calculate the expected variability in expected cash flows for each scenario in accordance with the VIE model.
Table C-6 illustrates the calculation of the variability for the three scenarios:

<table>
<thead>
<tr>
<th>Scenario</th>
<th>Probability-Weighted Discounted Expected Cash Flows</th>
<th>Probability</th>
<th>Variability*</th>
<th>Expected Losses</th>
<th>Expected Residual Returns</th>
</tr>
</thead>
<tbody>
<tr>
<td>Scenario 1</td>
<td>$3,183,880</td>
<td>25%</td>
<td>$579,222</td>
<td>$579,222</td>
<td></td>
</tr>
<tr>
<td>Scenario 2</td>
<td>5,451,098</td>
<td>50</td>
<td>241,782</td>
<td>241,782</td>
<td>241,782</td>
</tr>
<tr>
<td>Scenario 3</td>
<td>1,783,654</td>
<td>25</td>
<td>(821,004)</td>
<td>(821,004)</td>
<td>(821,004)</td>
</tr>
<tr>
<td></td>
<td>$10,418,632</td>
<td>100%</td>
<td>$821,004</td>
<td>$821,004</td>
<td>$821,004</td>
</tr>
</tbody>
</table>

* Variability is calculated as follows (example for Scenario 1):

- Discounted expected cash flows above $10,418,632
- Multiply by probability of scenario 25%
- Probability-weighted amount $2,604,658
- Probability-weighted discounted expected cash flows of Scenario 1 $3,183,880
- Less probability-weighted amount $2,604,658
- Variability $579,222

The term “expected losses” does not refer to what a legal entity or variable interest holder expects to lose but to the variability in the cash flows to be absorbed by the variable interest holder. Negative variability results in an expected loss scenario, and positive variability results in an expected residual return scenario. In this example, the expected losses of PowerCo are $821,004. Because PowerCo has equity investment at risk of $2 million, its equity is sufficient to cover the expected losses of the entity. However, just because there is sufficient equity investment at risk does not mean PowerCo is not a VIE. Rather, PowerCo would also have to consider the other two characteristics in ASC 810-10-15-14, including the impact on the ManageCo contract on the assessment of ASC 810-10-15-14.
Appendix D — Voting Interest Entity Model

* Consolidation is not required; however, other GAAP may be relevant to the determination of recognition, measurement, or disclosure.
A reporting entity with an economic interest in a legal entity that does not qualify for a general exception to the requirements for consolidation must apply the consolidation guidance in ASC 810-10. That guidance is presented in the following three main subsections: (1) “General,” (2) “Variable Interest Entities,” and (3) “Consolidation of Entities Controlled by Contract.”

Only after the reporting entity has determined that the legal entity is not subject to the VIE model (see Chapter 5) does it apply the “general” guidance or the guidance on the consolidation of entities controlled by contract.

The general guidance applies to voting interest entities (referred to hereafter as the “voting interest entity model”). The guidance on the consolidation of entities controlled by contract (referred to hereafter as the “contract-controlled entity model”) applies in certain situations in which a legal entity that is not a VIE is controlled through a contractual management relationship. Under both the voting interest entity model and the contract-controlled entity model, a reporting entity consolidates a legal entity when it has a controlling financial interest in the legal entity. This appendix provides additional guidance on the voting interest entity and contract-controlled entity models. See Table 1-1 in Section 1.4 for differences between the voting interest entity model and the VIE model.

In addition, as part of its consolidation reorganization project, the FASB issued a proposed ASU in September 2017 that would move or amend the guidance related to the contract-controlled entity model. See Section D.3.4 for more information.

The determination of whether a reporting entity should consolidate a voting interest entity is a continual process. That is, the reporting entity should monitor specific transactions or events that affect whether it holds a controlling financial interest.

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1 As discussed in Section 3.3, there are four general exceptions to the consolidation requirements for a legal entity. Broadly speaking, the exceptions apply to (1) employee benefit plans, (2) investment companies, (3) governmental entities, and (4) money market funds.
D.1 General Consolidation Principles

The flowchart below shows the detailed steps that a reporting entity should follow when evaluating a legal entity under the voting interest entity model.

Is the legal entity a limited partnership or similar entity? (See Section 5.3.1.2.1.)

Does the reporting entity own a majority voting interest? (See Section D.1.3.)

Does the noncontrolling shareholders have substantive participating rights? (See Section D.2.)

Do any of the exceptions to consolidation by owner of a majority voting interest apply? (See Section D.1.3.2.)

Do the other limited partners have substantive participating rights? (See Section D.2.)

Does the reporting entity have the unilateral right to remove the general partner or similar decision maker? (See Section D.1.6.)

Does the reporting entity have control without a majority voting interest? (See Section D.1.3.1.)

Do the reporting entity have a unilateral liquidation right? (See Section D.1.6.2.)

Consolidate.

Consolidate.

Do not consolidate.
Throughout this Subtopic, any reference to a limited partnership includes limited partnerships and similar legal entities. A *similar legal entity* is an entity (such as a limited liability company) that has governing provisions that are the functional equivalent of a limited partnership. In such entities, a managing member is the functional equivalent of a general partner, and a nonmanaging member is the functional equivalent of a limited partner.

For legal entities other than limited partnerships, the usual condition for a controlling financial interest is ownership of a majority voting interest, and, therefore, as a general rule ownership by one reporting entity, directly or indirectly, of more than 50 percent of the outstanding voting shares of another entity is a condition pointing toward consolidation. The power to control may also exist with a lesser percentage of ownership, for example, by contract, lease, agreement with other stockholders, or by court decree.

Given the purpose and design of limited partnerships, kick-out rights through voting interests are analogous to voting rights held by shareholders of a corporation. For limited partnerships, the usual condition for a controlling financial interest, as a general rule, is ownership by one limited partner, directly or indirectly, of more than 50 percent of the limited partnership's kick-out rights through voting interests. The power to control also may exist with a lesser percentage of ownership, for example, by contract, lease, agreement with partners, or by court decree.

A majority-owned subsidiary is an entity separate from its parent and may be a variable interest entity (VIE) that is subject to consolidation in accordance with the Variable Interest Entities Subsections of this Subtopic. Therefore, a reporting entity with an explicit or implicit interest in a legal entity within the scope of the Variable Interest Entities Subsections shall follow the guidance in the Variable Interest Entities Subsections.

A reporting entity shall apply consolidation guidance for entities that are not in the scope of the Variable Interest Entities Subsections (see the Variable Interest Entities Subsection of this Section) as follows:

- All majority-owned subsidiaries — all entities in which a parent has a controlling financial interest — shall be consolidated. However, there are exceptions to this general rule.
  1. A majority-owned subsidiary shall not be consolidated if control does not rest with the majority owner — for instance, if any of the following are present:
    - The subsidiary is in legal reorganization
    - The subsidiary is in bankruptcy
    - The subsidiary operates under foreign exchange restrictions, controls, or other governmentally imposed uncertainties so severe that they cast significant doubt on the parent’s ability to control the subsidiary.
  2. In some instances, the powers of a shareholder with a majority voting interest or limited partner with a majority of kick-out rights through voting interests to control the operations or assets of the investee are restricted in certain respects by approval or veto rights granted to the noncontrolling shareholder or limited partner (hereafter referred to as noncontrolling rights). In paragraphs 810-10-25-2 through 25-14, the term *noncontrolling shareholder* refers to one or more noncontrolling shareholders and the terms *limited partner* and *general partner* refer to one or more limited or general partners. Those noncontrolling rights may have little or no impact on the ability of a shareholder with a majority voting interest or limited partner with a majority of kick-out rights through voting interests to control the investee’s operations or assets, or, alternatively, those rights may be so restrictive as to call into question whether control rests with the majority owner.
  3. Control exists through means other than through ownership of a majority voting interest or a majority of kick-out rights through voting interests, for example as described in (c) through (e).

2. A majority-owned subsidiary in which a parent has a controlling financial interest shall not be consolidated if the parent is a broker-dealer within the scope of Topic 940 and control is likely to be temporary.

ASC 810-10 (continued)

b. Subparagraph superseded by Accounting Standards Update No. 2015-02.
c. Subtopic 810-30 shall be applied to determine the consolidation status of a research and development arrangement.
d. The Consolidation of Entities Controlled by Contract Subsections of this Subtopic shall be applied to determine whether a contractual management relationship represents a controlling financial interest.
e. Paragraph 710-10-45-1 addresses the circumstances in which the accounts of a rabbi trust that is not a VIE (see the Variable Interest Entities Subsections for guidance on VIEs) shall be consolidated with the accounts of the employer in the financial statements of the employer.

25-1 For legal entities other than limited partnerships, consolidation is appropriate if a reporting entity has a controlling financial interest in another entity and a specific scope exception does not apply (see Section 810-10-15). The usual condition for a controlling financial interest is ownership of a majority voting interest, but in some circumstances control does not rest with the majority owner.

25-1A Given the purpose and design of limited partnerships, kick-out rights through voting interests are analogous to voting rights held by shareholders of a corporation. Consolidation is appropriate if a reporting entity has a controlling financial interest in a limited partnership and a specific scope exception does not apply (see Section 810-10-15). The usual condition for a controlling financial interest in a limited partnership is ownership of a majority of the limited partnership's kick-out rights through voting interests, but, in some circumstances, control does not rest with the majority owner.

ASC 810-10 — Glossary

Kick-Out Rights (Voting Interest Entity Definition)
The rights underlying the limited partner's or partners' ability to dissolve (liquidate) the limited partnership or otherwise remove the general partners without cause.

Under the voting interest entity model, a reporting entity consolidates a legal entity when it has a controlling financial interest in the legal entity through its ownership of voting interests. Limited partnerships that are not VIEs are evaluated for consolidation in essentially the same manner as corporations that are not VIEs. More specifically, under the voting interest entity model, if there is a presumption that a party controls an entity (i.e., a party holding over 50 percent of the voting interest in a corporation or a party in a limited partnership holding unilateral kick-out or liquidation rights), a reporting entity must consider whether that presumption is overcome because of the existence of substantive participating rights held by other parties.

D.1.1 Limited Partnerships (and Similar Entities)
Under the voting interest entity model, a general partner will not consolidate a limited partnership. Rather, the concept of a controlling financial interest is premised on whether a limited partner owns substantive kick-out rights that give it the unilateral right to, without cause, remove the general partner or dissolve the partnership.

2 Hereafter, unless otherwise specifically noted, “voting interests” refer to voting shares for legal entities other than limited partnerships and kick-out rights for limited partnerships.
3 For a discussion of what is meant by “similar” entities, see Section 5.3.1.2.1.
4 As discussed in Section 5.3.1.2, if a simple majority or lower threshold (including a single limited partner) of “unrelated” limited partners (i.e., parties that are not under common control with, or acting on behalf of, the general partner) with equity at risk is unable to exercise substantive kick-out rights or substantive participating rights, the limited partnership is a VIE. Thus, limited partnerships that were consolidated by the general partner under the voting interest entity model before ASU 2015-02 are now subject to consolidation under the VIE subsections of ASC 810-10. Accordingly, a general partner will not consolidate a limited partnership under the voting interest entity model. See Chapter 7 for discussion of when a general partner would consolidate a limited partnership that is a VIE.
D.1.2 Legal Entities That Are Not Limited Partnerships (or Similar Entities)

For legal entities that are not limited partnerships, a controlling financial interest is premised on whether a reporting entity has voting interests that give it control over the financial and operating policies of the legal entity. A controlling financial interest typically exists when a reporting entity owns more than 50 percent of the outstanding voting shares of another entity. However, there are exceptions to this general principle, as discussed below.

D.1.3 General Concept of Control

There is no precise definition in the authoritative accounting literature of “control” as it applies to consolidation and related matters. ASC 850-10-20 states that control is the “possession, direct or indirect, of the power to direct or cause the direction of the management and policies of an entity through ownership, by contract, or otherwise.” This definition of control is substantively the same as that in SEC Regulation S-X, Rule 1-02(g).

ASC 810-10-15-8 and 15-8A indicate that an investor with a majority voting interest, or a limited partner with a majority of kick-out rights through voting interests, will generally control a legal entity. However, ASC 810-10-15-8 and 15-8A also provide exceptions to this guidance and indicate that the power to control may also exist with a lesser percentage of ownership, for example, by contract, lease, agreement with other owners of voting interests, or court decree. Therefore, conclusions about control should be based on an evaluation of the specific facts and circumstances. In some situations, an investor with less than a majority voting interest, or a limited partner with less than a majority of kick-out rights, can control a legal entity. In other situations, the power of a stockholder with a majority voting interest, or a limited partner with a majority of kick-out rights, to control a legal entity does not exist with the majority owner because of noncontrolling rights or as a result of other factors.

D.1.3.1 Control Without a Majority Voting Interest

In the absence of participating rights held by other parties, the following factors may indicate substantive control of a legal entity by an investor, even if the investor does not own a majority of the voting interests in the legal entity:

- For legal entities other than limited partnerships, control of the board of directors/governing body or other decision-making body that is responsible for making the significant decisions of the entity.
- For limited partnerships, ASC 810-10-15-8A states that “kick-out rights through voting interests are analogous to voting rights held by shareholders of a corporation.” Therefore, the usual condition for a controlling financial interest in a limited partnership, as a general rule, is ownership by one limited partner, directly or indirectly, of more than 50 percent of the limited partnership’s kick-out rights through voting interests.
- Notwithstanding lack of ownership of a majority of voting interests by contract, lease, agreement with other owners of voting interests, or court decree, an investor has control of sufficient proxy rights for a majority of the voting interests of a legal entity.
- The investor has the ability to unilaterally set or significantly change the operating or capital policies of the investee, including budgets, in the ordinary course of business.
- Possession of options or other securities convertible into voting interests, if such securities are currently exercisable, at little or no economic cost (see Section D.1.4).
The mere existence of a participating right or a protective right would not give a reporting entity that lacks majority voting interests a controlling financial interest in a legal entity. For guidance on the accounting in such a scenario, including a situation in which a joint venture arrangement may exist, see Deloitte’s *A Roadmap to Accounting for Equity Method Investments and Joint Ventures*.

**Example D-1**

Company X previously owned 90 percent of the common stock in Company Y (a corporation), controlled the election of directors to Y’s board, and had voting power over Y. All of Y’s significant decisions are made by Y’s board. Company X subsequently sold 40 percent of its common stock investment in Y, reducing its voting interest in Y to 50 percent. However, X continued to control the election of directors to Y’s board, and the other equity holders did not have substantive participating rights. Company Y is not a VIE.

In this example, X would continue to consolidate Y even though it no longer owns a majority voting interest in Y because X controls the board of directors and governing body of Y.

**D.1.3.2 Lack of Control With a Majority Voting Interest**

The powers of a stockholder with a majority voting interest, or a limited partner with a majority of kick-out rights, to control a legal entity does not exist with the majority owner when other investors have substantive participating rights (see Section D.2 for discussion of participating rights). In addition, when any of the following conditions exist, an investor does not have control over a legal entity even if the investor owns a majority of the voting interests in the legal entity:

- The legal entity is undergoing a legal reorganization.
- The legal entity is in bankruptcy.
- The legal entity is operating under foreign exchange restrictions, controls, or other governmentally imposed uncertainties that are so severe that they cast significant doubt on the controlling shareholder’s ability to control the legal entity.
- The governing provisions of a legal entity other than a limited partnership require greater than a simple majority vote to approve decisions regarding the financial and operating policies of the legal entity that are made in the ordinary course of the legal entity’s business.\(^5\)
- The legal entity is temporarily controlled by a parent that is a broker-dealer within the scope of ASC 940.

See Section D.3 for additional discussion of these situations.

**D.1.4 Consideration of Potential Voting Rights in Evaluating Control**

A reporting entity may hold certain contractual rights that allow it to acquire additional voting interests in a legal entity. For example, the reporting entity may have a call option to purchase additional equity in a legal entity that is not a limited partnership (or a limited partner may have the contractual right to purchase limited partnership interests held by other limited partners). Potential voting rights may also exist through other types of securities that are convertible into voting interests (e.g., convertible securities).

\(^5\) If the right to remove the general partner of a limited partnership requires the exercise of more than a simple majority of kick-out rights, the limited partnership is a VIE. See additional discussion in Section 5.3.1.2.
ASC 810-10 does not specifically address how to consider potential voting rights in determining whether a reporting entity has a controlling financial interest in a legal entity that is not a VIE (other than the impact that potential voting rights may have on the determination of whether a participating right is substantive — see additional discussion in Section D.2.3). As a general principle, the assessment of control of a legal entity that is not a VIE should be made on the basis of existing voting interests owned (and other existing contractual agreements that permit control at the time of assessment) as opposed to contingent actions or events that must occur before a controlling financial interest is obtained (e.g., exercising a call option and purchasing additional voting interests in a legal entity). Thus, a potential voting right would not typically affect the determination of whether a controlling financial interest is present. However, potential voting rights may reflect substantive control over a legal entity if a reporting entity can obtain the additional voting interests at little or no economic cost; that is, when the purchase price is considered nonsubstantive. A reporting entity must use significant judgment and evaluate all relevant facts and circumstances to determine whether the purchase price is nonsubstantive.

The above discussion focuses on potential voting rights that may be obtained by a reporting entity through the acquisition of additional voting interests in a legal entity. The same general principle discussed above would also apply when a reporting entity that does not own a majority of voting interests has an existing contract, lease, or other agreement that will give the reporting entity a controlling financial interest in the future. That is, such contract or agreement would typically not result in the reporting entity's possession of a controlling financial interest until the date at which it obtains control. However, all facts and circumstances must be considered. For example, the reporting entity may be deemed to currently have a controlling financial interest if, on the basis of the terms of the contract, lease, or other agreement, no significant actions regarding the financial and operating policies of the reporting entity may be taken before the date on which the reporting entity obtains the controlling financial interest.

Under the voting interest entity model, potential voting rights that may be (or will be) obtained in the future (e.g., potential voting rights that may be obtained with little or no economic cost on a future date, which would include a limited partner's ability to remove the general partner or liquidate the limited partnership) will have no impact on the consolidation analysis unless (or until) the possibility is remote (i.e., it is not reasonably possible) that significant decisions in the ordinary course of business will be made before the date the potential voting right is exercisable. In making this determination, the reporting entity must exercise significant judgment in light of all relevant facts and circumstances. In many cases, there may be nothing to preclude a majority investor from taking a significant action before the date the potential voting right becomes exercisable.

**D.1.5 Consideration of Indirect Ownership Interests in Evaluating Control**

In determining whether a controlling financial interest is present, a reporting entity should consider not only its directly owned voting interests but also any voting interests indirectly owned in a legal entity. In certain instances, a reporting entity that does not directly hold a majority of voting interests in a legal entity may have a controlling financial interest in the legal entity through a combination of direct and indirect voting interests.

An indirect voting interest is deemed to exist when a reporting entity controls another owner of voting interests in a legal entity. If a reporting entity controls another investor in the legal entity, the reporting entity should consider the voting interests owned by the other investor in its analysis of whether it has a controlling financial interest in a legal entity. The consideration of indirectly owned voting interests is required even if the reporting entity does not consolidate the other investor (because, for example, the legal entity qualifies for an exception to the consolidation requirements in ASC 810-10).

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6 Potential voting rights could, however, affect the assessment of whether a legal entity is a VIE when those interests represent variable interests in a legal entity.
However, note that under the voting interest entity model, in the absence of a contract or other agreement that gives a reporting entity the right to vote for the interests held by its related parties, the reporting entity is not required to consider the voting interests owned by its related parties that it does not control.

**Example D-2**

Reporting Entity A owns 60 percent of Entity B (a corporation) and consolidates it under ASC 810-10. Entity B owns 51 percent of Entity C (a corporation) and consolidates it under ASC 810-10. Reporting Entity A indirectly controls C through B and should consolidate C (through A’s consolidation of B) even though the noncontrolling interest would be more than 69 percent (noncontrolling interest in Entity B of 40% × 51% of Entity C = 20.4%, added to 49% “other” ownership in Entity C = 69.4%).

In the above scenario, if A did not control (i.e., consolidate) B, A would not indirectly control C and would not consolidate C.

**Example D-3**

Reporting Entity A owns 60 percent of the limited partnership interests in Partnership B and 10 percent of the limited partnership interests in Partnership C. Partnership B owns 49 percent of the limited partnership interests in Partnership C. The respective general partner of both B and C may be removed by a simple majority vote of limited partners that have substantive kick-out rights and are not under common control with, or acting on behalf of, the general partner. Other limited partners do not have substantive participating rights. Reporting Entity A controls C through direct ownership (10 percent) and indirect ownership (49 percent held by B, a majority-owned subsidiary) of the limited partnership interests in C and therefore should consolidate C. Although A is required to consolidate C because it has control through direct and indirect ownership of voting interests, B would not consolidate C in its separate financial statements because A’s ownership in C is not attributed to B.

**Example D-4**

Reporting Entity A owns 49 percent of Entity B (a corporation) and 40 percent of Entity C (a corporation). Entity B owns 40 percent of C. Reporting Entity A does not control and should not consolidate B. Reporting Entity A also would not consolidate C despite having an almost 60 percent combined direct and indirect ownership interest in C because Entity A does not unilaterally control B’s voting interest in C.
D.1.6 Consideration of Kick-Out Rights for Limited Partnerships

As noted in ASC 810-10-25-1A, kick-out rights in a limited partnership are viewed as the equivalent of voting shares in a corporation. Accordingly, in the absence of participating rights held by other limited partners, a limited partner that owns substantive kick-out rights that give it the unilateral right to, without cause, remove the general partner or dissolve the partnership would have a controlling financial interest in the limited partnership. A reporting entity must evaluate the relevant facts and circumstances under ASC 810-10-25-14A through 25-14C to determine whether a kick-out right is substantive (see additional discussion in Section D.2.3.1).

The guidance in ASC 810-10-25-14A through 25-14C on whether kick-out rights are substantive should be applied in the determination of whether (1) a limited partnership is a VIE under ASC 810-10-15-14(b)(1)(ii) and (2) whether a single limited partner has a controlling financial interest in a limited partnership. If a conclusion is reached that the kick-out rights held by limited partners are not substantive (and the limited partners are not able to exercise substantive participating rights), then the limited partnership would be a VIE and not a voting interest entity. It is not possible to conclude that the same kick-out rights are (1) substantive in the evaluation of whether a limited partnership is a VIE and (2) nonsubstantive in the evaluation of whether a majority owner of limited partnership interests has a controlling financial interest in the limited partnership.

D.1.6.1 Kick-Out Rights Held by Related Parties

In discussing the consolidation of limited partnerships that are voting interest entities, ASC 810-10-15-8A refers to ownership by one limited partner “directly or indirectly” of more than 50 percent of the limited partnership’s kick-out rights through voting interests. Although not specifically addressed in ASC 810-10, the concept of owning kick-out rights “indirectly” does not extend beyond the ownership of kick-out rights through the control of another limited partner that also owns kick-out rights through voting interests. That is, for a limited partnership that is not a VIE, in the absence of a contract or other agreement that gives the limited partner the right to vote the kick-out rights held by its related parties, the limited partner is not required to consider the kick-out rights held by its related parties that it does not control. Rather, the limited partner is only required to consider the nature of related-party relationships to determine whether a noncontrolling interest right is a substantive participating right.

Example D-5

Reporting Entity A owns 49 percent of the limited partnership interests of Partnership B and 40 percent of the voting shares of Entity C (a corporation), which owns 40 percent of the limited partnership interests in B. Reporting Entity A accounts for its investment in C by using the equity method of accounting. Reporting Entity A does not control and should not consolidate B. Although A has a combined direct and indirect limited partnership interest of 65 percent (49% + [40% × 40%]) in B, A does not unilaterally control the kick-out rights of B because it exerts only significant influence over the limited partnership interests owned indirectly through C.

D.1.6.2 Evaluation of Liquidation and Withdrawal Rights as Kick-Out Rights

As discussed in Section 2.4, two different definitions of kick-out rights apply depending on whether the legal entity is (1) a limited partnership (or similar entity) that uses the voting interest entity definition or (2) other than a limited partnership (or similar entity) that uses the VIE definition. According to the definition of a voting interest entity in the ASC master glossary, the right “to dissolve (liquidate) the limited partnership . . . without cause” is a kick-out right.

Paragraph BC49 of ASU 2015-02 provides the FASB’s thoughts regarding the evaluation of liquidation rights and notes that they “should be considered equivalent to kick-out rights [because they] provide
the holders of such rights with the ability to dissolve the entity and, thus, effectively remove the decision maker's authority. Paragraph BC49 of ASU 2015-02 further indicates that the Board considered, but rejected, evaluating liquidation rights in a manner similar to kick-out rights “only when it is reasonable that upon liquidation, the investors will receive substantially all of the specific assets under management and can find a replacement manager with sufficient skills to manage those assets.” As noted in paragraph BC49 of ASU 2015-02, the “Board ultimately rejected this view because the outcome for the decision maker is the same regardless of whether the holders of those rights have the ability to obtain the specific assets from the entity upon liquidation or identify an alternative manager [because if] the holders exercise their substantive liquidation rights, similar to kick-out rights, the decision maker’s abilities would be removed.” Therefore, any liquidation right should be considered a kick-out right and would result in a limited partner’s consolidation of a limited partnership that is not a VIE as long as the right (1) is substantive and (2) gives a single limited partner the unilateral ability to liquidate a limited partnership. If these conditions are met, the single limited partner would consolidate the limited partnership even if other limited partners have substantive participating rights before liquidation. That is, we believe that a noncontrolling limited partner’s right to exercise a substantive participating right is not relevant to the consolidation analysis when a limited partner has a substantive ability to liquidate the limited partnership, because the potential liquidation effectively negates any participation right.

It is important to distinguish liquidation rights from withdrawal rights since ASC 810-10-25-14B indicates that a reporting entity’s unilateral right to withdraw from an entity that does not require dissolution or liquidation of the entire entity “would not be deemed a kick-out right.” Therefore, a reporting entity should carefully analyze withdrawal rights to determine whether, on the basis of the specific facts and circumstances, they represent liquidation rights.

This may be the case when a limited partnership has only a single limited partner or when a limited partnership’s formation documents require the dissolution of the limited partnership upon exercise of the withdrawal right (e.g., as a result of the exercise of the withdrawal right, the amount of the limited partnership’s remaining assets may decline to a level that triggers dissolution). Withdrawal rights that do not require the dissolution or liquidation of the entire limited partnership do not represent liquidation rights and therefore should not be considered kick-out rights. Furthermore, when the exercise of a withdrawal right does require the dissolution or liquidation of the entire limited partnership, the right should only result in a limited partner’s consolidation of a limited partnership if the right (1) is substantive and (2) gives a single limited partner the unilateral ability to withdraw and cause either the dissolution or liquidation of the limited partnership. In a manner consistent with a liquidation right discussed above, if these conditions are met, the single limited partner with such a withdrawal right would consolidate the limited partnership even if other limited partners have substantive participating rights before liquidation.

Note also that special consideration is necessary when a liquidation right (or a withdrawal right that represents a liquidation right) is exercisable in the future. In these situations, the right should be evaluated in the same manner as other potential voting rights (see Section D.1.4).

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7 Paragraph BC49 of ASU 2015-02 states that “Barriers to exercise may be different when considering kick-out rights as compared with barriers for liquidation rights and should be evaluated appropriately when assessing whether the rights are substantive.”

8 As stated in ASC 810-10-25-14B, “[t]he requirement to dissolve or liquidate the entire limited partnership upon the withdrawal of a limited partner or partners shall not be required to be contractual for a withdrawal right to be considered as a potential kick-out right.” Therefore, a reporting entity must determine, on the basis of the facts and circumstances, whether the practical result of the withdrawal will be the required dissolution of the partnership (e.g., the partnership has only one limited partner and the general partner has a nominal interest) or its liquidation.

9 See footnote 7.
D.1.6.2.1 Evaluation of Buy-Sell Clauses as a Liquidation Right

A buy-sell term in a contractual agreement can take various forms. However, in an arrangement in which two investors each own 50 percent of an entity, a buy-sell clause generally gives each investor the ability to offer to buy out the entire equity interest of another investor (the "offeree") upon giving notice to the offeree. The investor making the offer (the "offeror") typically names a price for the offeree's interest at its discretion. After receiving the offer from the offeror, the offeree typically is contractually required to either (1) sell its entire interest in the entity to the offeror at the named price or (2) buy the offeror's interest at the named price. Buy-sell agreements are not typically considered liquidation rights. See Example 5-31.

D.1.7 Reassessment of Controlling Rights

The initial assessment of controlling rights should be made at the time the reporting entity becomes involved with the voting interest entity. However, rights should be reassessed on a continual basis, and the reporting entity should monitor specific transactions or events that may affect whether it still holds a controlling (or noncontrolling) financial interest in the voting interest entity. Examples of events that may affect this assessment and therefore should be considered include, but are not limited to:

- Changes in the total number of shareholders or limited partners and total outstanding voting interests.
- Changes in ownership percentages and corresponding changes to voting rights or decision-making rights.
- Amendments to governance documents that may affect voting interests or decision-making rights.
- Changes in exercisability of potential voting rights. See Section D.1.4.

When a reporting entity considers these events, it should also assess whether the events would qualify as VIE reconsideration events (see Chapter 9 for more information).

D.2 The Effect of Noncontrolling Rights on Consolidation

ASC 810-10

25-2 Paragraph 810-10-15-10(a)(1)(iv) explains that, in some instances, the powers of a shareholder with a majority voting interest or limited partner with a majority of kick-out rights through voting interests to control the operations or assets of the investee are restricted in certain respects by approval or veto rights granted to the noncontrolling shareholder or limited partner (referred to as noncontrolling rights). That paragraph also explains that, in paragraphs 810-10-25-2 through 25-14, the term noncontrolling shareholder refers to one or more noncontrolling shareholders and the terms limited partner and general partner refer to one or more limited or general partners. Paragraph 810-10-15-10(a)(1)(iv) explains that those noncontrolling rights may have little or no impact on the ability of a shareholder with a majority voting interest or limited partner with a majority of kick-out rights through voting interests to control the investee's operations or assets, or, alternatively, those rights may be so restrictive as to call into question whether control rests with the majority owner.
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| 25-3      | The guidance in paragraphs 810-10-25-1 through 25-14 shall be applied in assessing the impact on consolidation of noncontrolling shareholder or limited partner approval or veto rights in both of the following circumstances:  
   a. Investments in which the investor has a majority voting interest in investees that are corporations or analogous entities (such as limited liability companies that have governing provisions that are the functional equivalent of regular corporations), or investments in which a limited partner has a majority of kick-out rights through voting interests in a limited partnership  
   b. Other circumstances in which legal entities would be consolidated in accordance with generally accepted accounting principles (GAAP), absent the existence of certain approval or veto rights held by noncontrolling shareholders or limited partners. |
| 25-4      | The guidance in paragraphs 810-10-25-2 through 25-14 on noncontrolling rights does not apply in either of the following situations:  
   a. Entities that, in accordance with GAAP, carry substantially all of their assets, including investments in controlled entities, at fair value with changes in value reported in a statement of net income or financial performance  
   b. Investments in variable interest entities (VIEs) (see the Variable Interest Entities Subsection of Section 810-10-15). |
| 25-5      | The assessment of whether the rights of a noncontrolling shareholder or limited partner should overcome the presumption of consolidation by the investor with a majority voting interest or limited partner with a majority of kick-out rights through voting interests in its investee is a matter of judgment that depends on facts and circumstances. The framework in which such facts and circumstances are judged shall be based on whether the noncontrolling rights, individually or in the aggregate, allow the noncontrolling shareholder or limited partner to effectively participate in certain significant financial and operating decisions of the investee that are made in the ordinary course of business. Effective participation means the ability to block significant decisions proposed by the investor who has a majority voting interest or the general partner. That is, control does not rest with the majority owner because the investor with the majority voting interest cannot cause the investee to take an action that is significant in the ordinary course of business if it has been vetoed by the noncontrolling shareholder. Similarly, for limited partnerships, control does not rest with the limited partner with the majority of kick-out rights through voting interests if the limited partner cannot cause the general partner to take an action that is significant in the ordinary course of business if it has been vetoed by other limited partners. This assessment of noncontrolling rights shall be made at the time a majority voting interest or a majority of kick-out rights through voting interests is obtained and shall be reassessed if there is a significant change to the terms or in the exercisability of the rights of the noncontrolling shareholder or limited partner. |
| 25-6      | All noncontrolling rights could be described as protective of the noncontrolling shareholder’s or limited partner’s investment in the investee, but some noncontrolling rights also allow the noncontrolling shareholder or limited partner to participate in determining certain significant financial and operating decisions of the investee that are made in the ordinary course of business (referred to as participating rights). Participation means the ability to block actions proposed by the investor that has a majority voting interest or the general partner. Thus, the investor with the majority voting interest or the general partner must have the agreement of the noncontrolling shareholder or limited partner to take certain actions. Participation does not mean the ability of the noncontrolling shareholder or limited partner to initiate actions. |
Noncontrolling rights that are only protective in nature (referred to as protective rights) would not overcome the presumption that the owner of a majority voting interest or the limited partner with a majority of kick-out rights through voting interests shall consolidate its investee. Substantive noncontrolling rights that allow the noncontrolling shareholder or limited partner to effectively participate in certain significant financial and operating decisions of the investee that are made in the investee's ordinary course of business, although also protective of the noncontrolling shareholder's or limited partner's investment, shall overcome the presumption that the investor with a majority voting interest or limited partner with a majority of kick-out rights through voting interests shall consolidate its investee.

For purposes of this Subsection, decisions made in the ordinary course of business are defined as decisions about matters of a type consistent with those normally expected to be addressed in directing and carrying out the entity's current business activities, regardless of whether the events or transactions that would necessitate such decisions are expected to occur in the near term. However, it must be at least reasonably possible that those events or transactions that would necessitate such decisions will occur. The ordinary course of business definition would not include self-dealing transactions with controlling shareholders or limited partners.

Reporting entities must evaluate rights that are granted by law or by contract that are retained by noncontrolling shareholders (or noncontrolling limited partners in a limited partnership) to assess whether such rights have an impact on the determination of whether the reporting entity has a controlling financial interest in a legal entity. Noncontrolling rights can be broadly categorized as either (1) protective rights or (2) participating rights. Only participating rights can preclude consolidation of a legal entity by an investor with a majority voting interest or a limited partner with a majority of kick-out rights.

### D.2.1 Protective Rights

Noncontrolling rights (whether granted by contract or by law) that would allow the noncontrolling shareholder or limited partner to block corporate or partnership actions would be considered protective rights and would not overcome the presumption of consolidation by the investor with a majority voting interest or limited partner with a majority of kick-out rights through voting interests in its investee. The following list is illustrative of the protective rights that often are provided to the noncontrolling shareholder or limited partner but is not all-inclusive:

a. Amendments to articles of incorporation or partnership agreements of the investee
b. Pricing on transactions between the owner of a majority voting interest or limited partner with a majority of kick-out rights through voting interests and the investee and related self-dealing transactions
c. Liquidation of the investee in the context of Topic 852 on reorganizations or a decision to cause the investee to enter bankruptcy or other receivership
d. Acquisitions and dispositions of assets that are not expected to be undertaken in the ordinary course of business (noncontrolling rights relating to acquisitions and dispositions of assets that are expected to be made in the ordinary course of business are participating rights; determining whether such rights are substantive requires judgment in light of the relevant facts and circumstances [see paragraphs 810-10-25-13 and 810-10-55-1])
e. Issuance or repurchase of equity interests.

### ASC 810-10 — Glossary

**Protective Rights (Voting Interest Entity Definition)**

Rights that are only protective in nature and that do not allow the limited partners or noncontrolling shareholders to participate in significant financial and operating decisions of the limited partnership or corporation that are made in the ordinary course of business.
By definition, protective rights do not allow the noncontrolling shareholders or noncontrolling limited partners to participate in significant financial and operating decisions made in a corporation’s or limited partnership’s ordinary course of business. These types of rights do not overcome the presumption of consolidation of the corporation or limited partnership by the controlling financial interest holder. See Section D.2.3 for additional discussion of the evaluation of whether noncontrolling rights are substantive participating rights.

D.2.2 Participating Rights

ASC 810-10

25-11 Noncontrolling rights (whether granted by contract or by law) that would allow the noncontrolling shareholder or limited partner to effectively participate in either of the following corporate or partnership actions shall be considered substantive participating rights and would overcome the presumption that the investor with a majority voting interest or limited partner with a majority of kick-out rights through voting interests shall consolidate its investee. The following list is illustrative of substantive participating rights, but is not necessarily all-inclusive:

a. Selecting, terminating, and setting the compensation of management responsible for implementing the investee’s policies and procedures

b. Establishing operating and capital decisions of the investee, including budgets, in the ordinary course of business.

25-12 The rights noted in paragraph 810-10-25-11 are participating rights because, in the aggregate, the rights allow the noncontrolling shareholder or limited partner to effectively participate in certain significant financial and operating decisions that occur as part of the ordinary course of the investee's business and are significant factors in directing and carrying out the activities of the business. Individual rights, such as the right to veto the termination of management responsible for implementing the investee’s policies and procedures, should be assessed based on the facts and circumstances to determine if they are substantive participating rights in and of themselves. However, noncontrolling rights that appear to be participating rights but that by themselves are not substantive (see paragraphs 810-10-25-13 and 810-10-55-1) would not overcome the presumption of consolidation by the investor with a majority voting interest or limited partner with a majority of kick-out rights through voting interests in its investee. The likelihood that the veto right will be exercised by the noncontrolling shareholder or limited partner should not be considered when assessing whether a noncontrolling right is a substantive participating right.

ASC 810-10 — Glossary

Participating Rights (Voting Interest Entity Definition)

Participating rights allow the limited partners or noncontrolling shareholders to block or participate in certain significant financial and operating decisions of the limited partnership or corporation that are made in the ordinary course of business. Participating rights do not require the holders of such rights to have the ability to initiate actions.

Participating rights allow the holder of such rights to participate in certain financial and operating decisions of an investee that occur “in the ordinary course of business” but do not require the holder to initiate actions. The retention of substantive participating rights by noncontrolling shareholders or noncontrolling limited partners would overcome the presumption that an investor with a majority voting interest should consolidate the investee. ASC 810-10-25-11 provides the following two examples of substantive participating rights that would preclude an investor with a majority voting interest from consolidating an investee: (1) selecting, terminating, and setting the compensation of management responsible for implementing the investee’s policies and procedures and (2) establishing operating and capital decisions of the investee (including budgets) in the ordinary course of business. The next section discusses additional considerations in the evaluation of whether noncontrolling rights are substantive participating rights.
D.2.3 Factors to Consider in Evaluating Whether Noncontrolling Rights Are Substantive Participating Rights

ASC 810-10

25-13 The following factors shall be considered in evaluating whether noncontrolling rights that appear to be participating are substantive rights, that is, whether these factors provide for effective participation in certain significant financial and operating decisions that are made in the investee's ordinary course of business:

a. Consideration shall be given to situations in which a majority shareholder or limited partner with a majority of kick-out rights through voting interests owns such a significant portion of the investee that the noncontrolling shareholder or limited partner has a small economic interest. As the disparity between the ownership interest of majority and noncontrolling shareholders or between the limited partner with a majority of kick-out rights through voting interests and noncontrolling limited partners increases, the rights of the noncontrolling shareholder or limited partner are presumptively more likely to be protective rights and shall raise the level of skepticism about the substance of the right. Similarly, although a majority owner is presumed to control an investee, the level of skepticism about such ability shall increase as the investor's or limited partner's economic interest in the investee decreases.

b. The governing documents shall be considered to determine at what level decisions are made — at the shareholder or limited partner level or at the board level — and the rights at each level also shall be considered. In all situations, any matters that can be put to a vote of the shareholders or limited partners shall be considered to determine if other investors, individually or in the aggregate, have substantive participating rights by virtue of their ability to vote on matters submitted to a shareholder or limited partner vote.

c. Relationships between the majority and noncontrolling shareholders or partners (other than an investment in the common investee) that are of a related-party nature, as defined in Topic 850, shall be considered in determining whether the participating rights of the noncontrolling shareholder or limited partner are substantive. For example, if the noncontrolling shareholder or limited partner in an investee is a member of the immediate family of the majority shareholder, general partner, or limited partner with a majority of kick-out rights through voting interests of the investee, then the rights of the noncontrolling shareholder or limited partner likely would not overcome the presumption of consolidation by the investor with a majority voting interest or limited partner with a majority of kick-out rights through voting interests in its investee.

d. Certain noncontrolling rights may deal with operating or capital decisions that are not significant to the ordinary course of business of the investee. Noncontrolling rights related to decisions that are not considered significant for directing and carrying out the activities of the investee's business are not substantive participating rights and would not overcome the presumption of consolidation by the investor with a majority voting interest or limited partner with a majority of kick-out rights through voting interests in its investee. Examples of such noncontrolling rights include all of the following:

1. Location of the investee's headquarters
2. Name of the investee
3. Selection of auditors
4. Selection of accounting principles for purposes of separate reporting of the investee's operations.

e. Certain noncontrolling rights may provide for the noncontrolling shareholder or limited partner to participate in certain significant financial and operating decisions that are made in the investee's ordinary course of business; however, the existence of such noncontrolling rights shall not overcome the presumption that the majority owner shall consolidate, if it is remote that the event or transaction that requires noncontrolling shareholder or limited partner approval will occur. Remote is defined in Topic 450 as the chance of the future event or events occurring being slight.
An owner of a majority voting interest or limited partner with a majority of kick-out rights through voting interests who has a contractual right to buy out the interest of the noncontrolling shareholder or limited partner in the investee for fair value or less shall consider the feasibility of exercising that contractual right when determining if the participating rights of the noncontrolling shareholder or limited partner are substantive. If such a buyout is prudent, feasible, and substantially within the control of the majority owner, the contractual right to buy out the noncontrolling owner or limited partner demonstrates that the participating right of the noncontrolling shareholder or limited partner is not a substantive right.

The existence of such call options, for purposes of the General Subsections, negates the participating rights of the noncontrolling shareholder or limited partner to veto an action of the majority shareholder or general partner, rather than create an additional ownership interest for that majority shareholder. It would not be prudent, feasible, and substantially within the control of the majority owner to buy out the noncontrolling shareholder or limited partner if, for example, either of the following conditions exists:

1. The noncontrolling shareholder or limited partner controls technology that is critical to the investee.
2. The noncontrolling shareholder or limited partner is the principal source of funding for the investee.

Paragraph 810-10-55-1 provides additional guidance on assessing substantive participating rights.

**25-14** An entity that is not controlled by the holder of a majority voting interest or holder of a majority of kick-out rights through voting interests because of noncontrolling shareholder or limited partner veto rights described in paragraphs 810-10-25-2 through 25-13 and 810-10-55-1 is not a VIE if the shareholders or partners as a group (the holders of the equity investment at risk) have the power to control the entity and the equity investment meets the other requirements of paragraphs 810-10-15-14 and 810-10-25-45 through 25-47, as applicable.

**Kick-Out Rights**

**25-14A** For limited partnerships, the determination of whether kick-out rights are substantive shall be based on a consideration of all relevant facts and circumstances. For kick-out rights to be considered substantive, the limited partners holding the kick-out rights must have the ability to exercise those rights if they choose to do so; that is, there are no significant barriers to the exercise of the rights. Barriers include, but are not limited to, the following:

a. Kick-out rights subject to conditions that make it unlikely they will be exercisable, for example, conditions that narrowly limit the timing of the exercise
b. Financial penalties or operational barriers associated with dissolving (liquidating) the limited partnership or replacing the general partners that would act as a significant disincentive for dissolution (liquidation) or removal
c. The absence of an adequate number of qualified replacement general partners or the lack of adequate compensation to attract a qualified replacement
d. The absence of an explicit, reasonable mechanism in the limited partnership’s governing documents or in the applicable laws or regulations, by which the limited partners holding the rights can call for and conduct a vote to exercise those rights
e. The inability of the limited partners holding the rights to obtain the information necessary to exercise them.

**25-14B** The limited partners' unilateral right to withdraw from the partnership in whole or in part (withdrawal right) that does not require dissolution or liquidation of the entire limited partnership would not be deemed a kick-out right. The requirement to dissolve or liquidate the entire limited partnership upon the withdrawal of a limited partner or partners shall not be required to be contractual for a withdrawal right to be considered as a potential kick-out right.

**25-14C** Rights held by the limited partners to remove the general partners from the partnership shall be evaluated as kick-out rights pursuant to paragraph 810-10-25-14A. Rights of the limited partners to participate in the termination of management (for example, management is outsourced to a party other than the general partner) or the individual members of management of the limited partnership may be substantive participating rights. Paragraphs 810-10-55-4N through 55-4W provide additional guidance on assessing kick-out rights.
Examples of how to assess individual noncontrolling rights facilitate the understanding of how to assess whether the rights of the noncontrolling shareholder or limited partner should be considered protective or participating and, if participating, whether the rights are substantive. An assessment is relevant for determining whether noncontrolling rights overcome the presumption of control by the majority shareholder or limited partner with a majority of kick-out rights through voting interests in an entity under the General Subsections of this Subtopic. Although the following examples illustrate the assessment of participating rights or protective rights, the evaluation should consider all of the factors identified in paragraph 810-10-25-13 to determine whether the noncontrolling rights, individually or in the aggregate, provide for the holders of those rights to effectively participate in certain significant financial and operating decisions that are made in the ordinary course of business:

a. The rights of the noncontrolling shareholder or limited partner relating to the approval of acquisitions and dispositions of assets that are expected to be undertaken in the ordinary course of business may be substantive participating rights. Rights related only to acquisitions that are not expected to be undertaken in the ordinary course of the investee's existing business usually are protective and would not overcome the presumption of consolidation by the investor with a majority voting interest or limited partner with a majority of kick-out rights through voting interests in its investee. Whether a right to approve the acquisition or disposition of assets is in the ordinary course of business should be based on an evaluation of the relevant facts and circumstances. In addition, if approval by the shareholder or limited partner is necessary to incur additional indebtedness to finance an acquisition that is not in the investee's ordinary course of business, then the approval by the noncontrolling shareholder or limited partner would be considered a protective right.

b. Existing facts and circumstances should be considered in assessing whether the rights of the noncontrolling shareholder or limited partner relating to an investee's incurring additional indebtedness are protective or participating rights. For example, if it is reasonably possible or probable that the investee will need to incur the level of borrowings that requires noncontrolling shareholder or limited partner approval in its ordinary course of business, the rights of the noncontrolling shareholder or limited partner would be viewed as substantive participating rights.

c. The rights of the noncontrolling shareholder or limited partner relating to dividends or other distributions may be protective or participating and should be assessed in light of the available facts and circumstances. For example, rights to block customary or expected dividends or other distributions may be substantive participating rights, while rights to block extraordinary distributions would be protective rights.

d. The rights of the noncontrolling shareholder or limited partner relating to an investee’s specific action (for example, to lease property) in an existing business may be protective or participating and should be assessed in light of the available facts and circumstances. For example, if the investee had the ability to purchase, rather than lease, the property without requiring approval of the noncontrolling shareholder or limited partner, then the rights of the noncontrolling shareholder or limited partner to block the investee from entering into a lease would not be substantive.

e. The rights of the noncontrolling shareholder or limited partner relating to an investee's negotiation of collective bargaining agreements with unions may be protective or participating and should be assessed in light of the available facts and circumstances. For example, if an investee does not have a collective bargaining agreement with a union or if the union does not represent a substantial portion of the investee's work force, then the rights of the noncontrolling shareholder or limited partner to approve or veto a new or broader collective bargaining agreement are not substantive.

f. Provisions that govern what will occur if the noncontrolling shareholder or limited partner blocks the action of an owner of a majority voting interest or general partner need to be considered to determine whether the right of the noncontrolling shareholder or limited partner to block the action has substance. For example, if the shareholder or partnership agreement provides that if the noncontrolling shareholder or limited partner blocks the approval of an operating budget, then the budget simply defaults to last year's budget adjusted for inflation, and if the investee is a mature business for which year-to-year operating budgets would not be expected to vary significantly, then the rights of the noncontrolling shareholder or limited partner to block the approval of the operating budget do not allow the noncontrolling shareholder or limited partner to effectively participate and are not substantive.
g. Noncontrolling rights relating to the initiation or resolution of a lawsuit may be considered protective or participating depending on the available facts and circumstances. For example, if lawsuits are a part of the entity's ordinary course of business, as is the case for some patent-holding companies and other entities, then the noncontrolling rights may be considered substantive participating rights.

h. A noncontrolling shareholder or limited partner has the right to veto the annual operating budget for the first X years of the relationship. Based on the facts and circumstances, during the first X years of the relationship this right may be a substantive participating right. However, following Year X there is a significant change in the exercisability of the noncontrolling right (for example, the veto right terminates). As of the beginning of the period following Year X, that right would no longer be a substantive participating right and would not overcome the presumption of consolidation by the investor with a majority voting interest or limited partner with a majority of kick-out rights through voting interests in its investee.

### D.2.3.1 Evaluating Whether Participating Rights Are Substantive

ASC 810-10-25-13 and ASC 810-10-55-1 provide factors and examples to help reporting entities determine whether noncontrolling rights represent substantive participating rights. The premise of this guidance is that even if rights granted to a noncontrolling shareholder (or limited partner) appear to be substantive, there may be other factors that limit the effect of those rights. Generally, rights to participate in decisions that are not expected to be made in the ordinary course of business (i.e., those related to matters whose likelihood of occurrence is remote or that apply only in exceptional circumstances) are considered protective rights. Rights to participate in decisions related to matters whose occurrence is at least reasonably possible in the ordinary course of business are participating rights. Reporting entities must use judgment to determine whether participating rights are substantive participating rights. The likelihood that an entity will exercise its rights is not considered in the assessment. Rather, if an entity has the right to participate in decisions, it is assumed that those rights will be exercised.

For example, the noncontrolling shareholder may have a right to veto the operating and capital decisions of the investee in the ordinary course of business, but its economic interest may be small, and the majority owner may have a call option on the noncontrolling shares whose exercise would be prudent, feasible, and substantially within the control of the majority owner. In such a scenario, the right to participate in the operating and capital decisions may not overcome control by the majority owner.

Likewise, a noncontrolling shareholder (or limited partner) may have a right to consent to the operating and capital decisions of the investee in the ordinary course of business, but the contractual agreement may specify that such consent “shall not be unreasonably withheld or delayed.” If an agreement includes such language related to the participating rights granted to the noncontrolling shareholder (or limited partner), the reporting entity should not presume that the participating rights are not substantive. While the ability of the noncontrolling shareholder (or limited partner) to exercise its rights may be constrained on the basis of that language, its presence in an agreement would not automatically result in a conclusion that the participating rights are not substantive. Rather, a reporting entity should assess why the agreement contains the language and obtain a detailed understanding of the consent process.

When determining whether consent rights are truly substantive, the reporting entity should also carefully assess whether the rights allow the noncontrolling shareholder to participate in decisions that are made in the ordinary course of business. The reporting entity must use significant judgment and consider all relevant facts and circumstances in making this determination. It may be helpful to consider what would happen if the noncontrolling shareholder tried to exercise a consent right related to an activity to which such language applied. There may be significant uncertainty related to whether the action of withholding or delaying consent is, in fact, reasonable (and an arbitrator or court proceeding...
might be needed to make that determination). Such uncertainty might call into question whether the majority interest holder actually has control over the decision. Further, a reporting entity should generally not analogize to situations in which the contractual language (e.g., “unreasonably withheld”) might apply to a more narrow set of decisions (e.g., transfer restrictions as described in Sections 5.3.1.1.2 and 8.2.3.4).

In addition, since ASC 810-10-25-14A defines substantive kick-out rights that are specific to limited partnerships, a reporting entity may analogize to that guidance when evaluating (1) kick-out rights related to legal entities other than limited partnerships or (2) approval or veto rights granted to a noncontrolling interest holder.

### Example D-6

Assume that Entity A and Entity B contributed certain assets to Entity C and that A and B own 60 percent and 40 percent, respectively, of the voting common shares of C. Assume that C is not a VIE. The operations of C are controlled by five managers, three of whom are appointed by A and two by B. Managers can be replaced only by the party that elected them. The following actions require the unanimous consent of all five managers:

- Borrowing money on behalf of C in an amount in excess of $500,000.
- Renewing, extending, modifying, rearranging, or refinancing borrowings by C in excess of $500,000.
- Acquiring, leasing, holding, or selling any or all real or personal property of C (or any interest therein) involving amounts or values in excess of $500,000.
- Paying or incurring any expense, debt, or obligation of C in excess of $500,000.
- Approving any long-term (more than one year) supply contract or other contract involving amounts in excess of $500,000.

The $500,000 approval limit represents less than 1 percent of C's estimated fair value upon formation. If the managers cannot reach unanimous agreement about an action, the action will be decided through an independent binding arbitration process.

In this scenario, A should not consolidate C. The rights granted in connection with the actions outlined above are expected to allow B to effectively participate in significant decisions that would be made in C's ordinary course of business. They therefore qualify as participating rights under ASC 810-10-25-11. Because A does not control C, A should account for its investment in C under the equity method.

Consider, however, a scenario in which the $500,000 approval limit represented 40 percent of C's estimated fair value upon formation. In such a case, because of the high approval threshold relative to the entity's estimated fair value, B is unable to effectively participate in significant decisions that would be made in C's ordinary course of business. Therefore, the rights granted to B would be considered protective, and A would consolidate C.

### Example D-6A

Entity A has a majority voting interest in Entity C, a voting interest entity; however, Entity B has the right to consent to decisions related to the following:

- Operating expenses in a fiscal year that exceed 135 percent of the aggregate amount of operating expenses for the immediately preceding fiscal year.
- Capital expenditures in any fiscal year that exceed an aggregate amount equal to 200 percent of the capital expenditures for the immediately preceding fiscal year.

Because C operates in a mature business for which year-to-year budgeted operating expenses would not be expected to vary significantly, A determines that its inability to unilaterally increase the budgeted operating expenses in a fiscal year by more than 135 percent of the expenses from the immediately preceding fiscal year does not prevent A from unilaterally making all of the necessary financial and operating decisions in the ordinary course of C's business.
Example D-6A (continued)

Further, because C is not a capital-intensive business, A determines that its inability to increase the budgeted capital expenditures by more than 200 percent of the expenditures from the immediately preceding fiscal year does not prevent A from unilaterally making all of the necessary financial (including capital) and operating decisions in the ordinary course of C’s business.

On the basis of these specific facts and circumstances, A may determine that B’s consent rights (individually and in the aggregate) do not represent substantive participating rights and that A therefore has a controlling financial interest in C.

Example D-6B

Entity A and Entity B form Entity C, a voting interest entity, and have 70 percent and 30 percent, respectively, of the ownership interests in C. Entity C was formed to own, develop, and operate a single commercial real estate property that is not subject to any lien or other form of indebtedness.

Entity A, as the manager, executes the day-to-day operations of C, for which A receives a separate management fee. However, the following major decisions related to the governance of C require unanimous approval of both A and B:

- Any decision to effect or undertake a material alteration in excess of $20 million, which represents 5 percent of C’s estimated fair value upon formation.
- Acquisition by C of any real property or other material asset apart from the single commercial real estate property.
- Extension of credit or the undertaking or modification of loans outside of the approved budget.

Since C was formed to manage a single commercial real estate property that was not expected to be altered after its development, A concludes that a material alteration is considered outside the normal course of business. In addition, because C was designed to hold the single commercial real estate property and not to acquire and manage other properties, A concludes that acquisition of additional properties is outside the normal course of business. Further, since the single commercial real estate property is not subject to any lien or other form of indebtedness, A concludes that the extension of credit or the undertaking or modification of loans is outside the ordinary course of business.

On the basis of these facts and circumstances, A may determine that B’s consent rights (individually and in the aggregate) do not represent substantive participating rights and that A therefore has a controlling financial interest in C.

Example D-6C

Assume the same facts as in Example D-6B but that A and B must unanimously approve the business plan, which includes the operating budget and capital budget for the single commercial real estate property.

If A and B approve the annual business plan, A, as the manager, is afforded the discretion to increase spending by no more than 10 percent or $1 million of the approved business plan for each line item as long as the total spending does not exceed the total budgeted spending by more than 5 percent.

As the manager, A concludes that its decision-making authority is constrained by the business plan because it is expected to operate C within the confines of the operating and capital budgets, which must be approved by B. However, as a result of failure to reach agreement on the proposed business plan (i.e., failure to obtain B’s approval), the operating budget automatically reverts to the prior-year budget (or the most recent unanimously approved budget).
Example D-6C (continued)

Although the prospect of defaulting to the prior-year budget (or most recent unanimously approved budget) could potentially suggest that B's participating right is not substantive, the specific facts and circumstances regarding C's underlying property would also need to be considered. For example, if the capital expenditures for the underlying commercial real estate property that were expected to be required in the ordinary course of business over the life of the entity were greater than those in the original approved budget, the fact that B must approve a budget increase may indicate that B has a substantive participating right.

Further, A and B must unanimously approve any execution, modification, or termination of a lease of the single commercial real estate property. Under ASC 810-10-25-13, a participating right is substantive if the holder has the ability to prevent a majority owner from making any significant ordinary-course financial or operating decision related to the entity. Therefore, B may have a substantive participating right since it has the right and the ability to block A from making the leasing decisions regarding the commercial real estate property (in the near term).

If the single commercial real estate property were under a long-term lease arrangement (and a substantive lease term remained) before A and B entered into the limited partnership, it may be unlikely that B would be able to exercise any substantive participating rights related to the leasing activities. However, if the property were vacant upon the formation of the limited partnership or if it were under a short-term lease, the facts and circumstances may lead to a conclusion that B has a substantive participating right.

However, the specific facts and circumstances should be carefully considered in the analysis of whether the above rights represent (individually or in the aggregate) substantive participating rights.

D.2.3.2 Noncontrolling Approval or Veto Rights Qualified by the Phrase “Other Than in the Ordinary Course of Business”

Situations have arisen in which a noncontrolling interest holder was granted substantive approval or veto rights and the terms of those rights were qualified by the phrase “other than in the ordinary course of business.” In situations in which that phrase was used to qualify a noncontrolling interest holder’s approval or veto rights and was vaguely defined, the SEC objected to consolidation by the majority owner. Accordingly, the contractual inclusion of undefined phrases such as “except in the normal course of business” or “other than in the ordinary course of business” is not considered sufficient to preclude a noncontrolling right, that would otherwise be considered a substantive participating right, from being treated as a substantive participating right. Rather, the reporting entity should evaluate the substance of the noncontrolling rights to determine whether the rights are substantive participating rights. Such an evaluation may include consideration of the following factors (not all-inclusive):

- The likelihood that the activity associated with the approval or veto rights will occur on the basis of the purpose and design of the entity, and the expected frequency of such occurrence(s).
- What could “trigger” the approval or veto rights held by the noncontrolling interest holder. In other words, the point at which the majority voting interest holder is no longer able to unilaterally direct the operating and capital decisions of the entity under the provision qualified by the phrase “except in the ordinary course of business” provision (i.e., whether frequency, size, or a combination of both triggers the approval or veto rights).
- Whether the majority voting interest holder has alternative means by which to complete the activity that would eliminate the need to consider or invoke the provision qualified by the phrase “except in the ordinary course of business” (e.g., approval of the operating and capital budget or other mechanisms).
- Other rights held by the noncontrolling interest holder, or the lack thereof, to participate in other activities of the legal entity.
Reporting entities may need the assistance of legal counsel in determining the substance of the noncontrolling interest holder’s rights.

This guidance also applies to non-SEC registrants.

**Example D-6D**

Entity A and Entity B each hold 50 percent of Entity C, which leases high-value construction equipment to its customers. Assume that C is not a VIE. The entities have an agreement under which A has the ability to appoint three members of C’s five-member board of directors, and B can appoint the two remaining members. The agreement also specifies that for several significant decisions, unanimous approval of the board must be obtained “other than in the normal course of business,” which the agreement does not define. Specifically, the applicable provision states, in part, that “the directors have no authority or power to take the following action without unanimous approval: purchase, take, receive, lease or otherwise acquire, own, hold, improve, sell, dispose, use, or otherwise deal in or with real or personal property or any interest in real or personal property, wherever situated, having a value greater than $100,000, other than in the normal course of business.” Making purchases or acquisitions of this nature is considered an action that will take place as part of directing and carrying out C’s current business activities.

In this example, the use of the phrase “other than in the normal course of business” does not preclude the unanimous-approval requirement from being a participating right because the meaning of that phrase is not defined and is not a “safe harbor” in which such a right is simply a protective right. Accordingly, to determine whether the right is participating or protective, the reporting entity must perform additional analysis of the relevant facts and circumstances (e.g., the purpose and design of the legal entity, legal counsel’s interpretation of the substance of the unanimous approval requirement), including how and when the right would be subject to approval with respect to directing and carrying out C’s business activities.

**D.2.3.3 Noncontrolling Rights to Block Acquisitions and Dispositions of Assets**

Under ASC 810-10-25-10, noncontrolling rights to block acquisitions and dispositions of assets that are not expected to be undertaken in the ordinary course of business are protective rights and would not overcome the presumption of consolidation by the investor with a majority voting interest or a limited partner with a majority of kick-out rights in its investee. Under previous guidance in EITF 96-16, there was a presumption that a noncontrolling interest holder’s right to block “[a]cquisitions and dispositions of assets greater than 20 percent of the fair value of the investee’s total assets” would be indicative of a protective right, whereas a noncontrolling interest holder’s right to block “[a]cquisitions and dispositions of 20 percent or less do not necessarily lead to the conclusion that it is a substantive participating right.” However, the FASB removed this 20 percent presumption when issuing EITF 04-5 and, instead, revised the language to focus on acquisitions and dispositions in the ordinary course of business. Therefore, a reporting entity must use judgment in determining whether, on the basis of the facts and circumstances, noncontrolling rights are participating or protective in nature.

**Example D-7**

Entity A and Entity B restructured a 50-50 (respective voting and economic ownership) corporate joint venture agreement involving Entity C. Under the agreement, A has 90 percent of the voting and economic interest in C, and control of the board. Entity A appoints all management of C and thus has management control of C’s operations. Assume that C is not a VIE. The stated purpose of the restructuring was to transfer control of C to A. The restructuring allows B to obtain liquidity for its investment in C and to extricate itself in part from C’s operations but also allows B to retain its financial interest in certain royalties and fixed payments through its remaining 10 percent economic ownership interest in C. However, one specific provision of the restructured operating agreement is that A cannot agree to make any transfer, in any transaction or series of transactions, of any asset or assets of C, the absence of which, singly or in the aggregate, would materially diminish or impair C’s primary business activities or C’s ability to conduct its primary business activities.
Example D-7 (continued)

In this example, the rights granted to B do not allow B to participate in the management or in the financial and operating decisions of C but rather protect its financial interest in the event that A decides to substantially change the nature, purpose, and design of C's primary business. The purpose of the provision is to ensure that A cannot eviscerate C's operations to the detriment of B. Therefore, the rights granted to B would not be sufficient to preclude A from consolidating C.

D.3 Exceptions to Consolidation by Owner of Majority Voting Interests

In addition to considering noncontrolling rights, under ASC 810-10-15-10(a)(1), a majority owner of voting interests would not consolidate a legal entity in the following circumstances:

- The subsidiary is undergoing a legal reorganization.
- The subsidiary is in bankruptcy.
- The subsidiary operates under foreign exchange restrictions, controls, or other governmentally imposed uncertainties that are so severe that they cast significant doubt on the parent's ability to control the subsidiary.
- Control exists through means other than ownership of a majority voting interest or a majority of kick-out rights. For example, a majority owner of voting interests would not consolidate a legal entity if:
  - ASC 810-30 is applied to determine the consolidation status of a research and development arrangement.
  - The subsections of ASC 810-10 on the consolidation of contract-controlled entities are applied to determine whether a contractual management relationship represents a controlling financial interest.
  - ASC 710-10-45-1 is applied. That paragraph addresses the circumstances in which the accounts of a rabbi trust that is not a VIE are consolidated with the accounts of the employer in the financial statements of the employer.

D.3.1 Subsidiaries in Bankruptcy

ASC 810-10-15-10(a)(1)(ii) states that a “majority-owned subsidiary shall not be consolidated if control does not rest with the majority owner — for instance, if [the] subsidiary is in bankruptcy.” In accordance with this guidance, a reporting entity should generally not consolidate a subsidiary that is in bankruptcy. Note, however, that because reporting entities generally cede control of a legal entity in bankruptcy to the bankruptcy court, the legal entity would typically be a VIE since the equity investors no longer control the legal entity (see Section 5.3.1). Nonetheless, regardless of whether a legal entity is a VIE or subject to the voting interest entity model, there may be certain circumstances in which it is appropriate for a reporting entity to continue to consolidate a subsidiary after it has filed for bankruptcy protection. This issue was addressed by an SEC staff member, Professional Accounting Fellow Randolph Green, in a speech at the 2003 AICPA Conference on Current SEC Developments:

Paragraph 13 of Statement 94 [not codified] indicates that “a majority owned subsidiary shall not be consolidated if control does not rest with the majority owner (as, for instance, if the subsidiary is in legal reorganization or in bankruptcy . . .).” I think most would conclude that bankruptcy is indicative of a loss of control and that deconsolidation is appropriate. However, paragraph 32 of SOP 90-7 [codified as ASC 852-10-45-14] suggests that there are conditions in which the continued consolidation of a subsidiary in bankruptcy is appropriate. [Footnotes omitted]
Recently, we were asked to consider whether the deconsolidation of a majority-owned subsidiary in bankruptcy was appropriate. We were willing to undertake such a consideration because, in part, we believe that, even when a subsidiary is in bankruptcy, there are circumstances where the continued consolidation of a subsidiary is more meaningful. For example, consider an instance where the parent has a negative investment, expects the bankruptcy to be brief, and expects further to regain control of the subsidiary. One might be appropriately concerned about the deconsolidation . . . and reconsolidation of a subsidiary by a parent in a short period of time.

In the fact pattern we considered, the parent was the majority common shareholder, a priority debt holder, and the subsidiary's single largest creditor. Due to its creditor position, the parent was able to negotiate a prepackaged bankruptcy with the subsidiary's other creditors. The parent, pursuant to the terms of the prepackaged bankruptcy, expected to maintain majority-voting control after the bankruptcy. The parent also expected the bankruptcy to be completed in less than one year.

While we are inclined to continue to believe that bankruptcy is indicative of the fact that control does not rest with the majority owner, we did not object to the parent's determination that the continued consolidation of its subsidiary during bankruptcy was more meaningful and that any loss of control would be temporary given the facts and circumstances.

Obviously, a determination that continued consolidation of a subsidiary in bankruptcy is appropriate requires a fairly unique set of facts and is appropriate only in infrequent and uncommon circumstances. It is not a conclusion that a registrant should make without thoroughly consulting with its auditors and one the company should consider discussing with us. In any event, the conclusion and its basis should be adequately disclosed and the company should periodically reassess its facts and circumstances to confirm the appropriateness of such a determination.

**D.3.1.1 Accounting for a Deconsolidated Subsidiary That Is in Bankruptcy**

Once a decision is made to deconsolidate a subsidiary that is in bankruptcy, the reporting entity should determine the appropriate method of accounting for its investment in the subsidiary after deconsolidation. In making such a determination, the reporting entity should consider whether it retains the ability to exercise significant influence over the operating and financial decisions of the subsidiary as described in ASC 323. ASC 323-10-15-6 specifies factors to consider, which include:

- The reporting entity’s representation on the subsidiary’s board of directors.
- The significance of the reporting entity’s role in the policy- and decision-making process for the subsidiary, including its role in determining the overall reorganization and plan for emergence from bankruptcy.
- The nature and significance of transactions between the reporting entity and its subsidiary.
- Whether the reporting entity and subsidiary share management employees.
- The technological interdependence of the reporting entity and subsidiary.

If it is determined that, notwithstanding the reporting entity’s loss of control of its subsidiary, the reporting entity continues to have the ability to exercise significant influence over the deconsolidated subsidiary, then the reporting entity should account for its investment in the subsidiary under the equity method. If the reporting entity has neither control nor the ability to exercise significant influence over its deconsolidated subsidiary, the reporting entity should account for its investment at fair value or in accordance with the measurement guidance in ASC 321-10-35-2.

10 See Chapter 3 of Deloitte’s *A Roadmap to Accounting for Equity Method Investments and Joint Ventures* for additional details.
D.3.2 Subsidiaries Operating Under Foreign Exchange Restrictions and Other Uncertainties

ASC 810-10-15-10(a)(1)(iii) states:

A majority-owned subsidiary shall not be consolidated if control does not rest with the majority owner — for instance, if [the] subsidiary operates under foreign exchange restrictions, controls, or other governmentally imposed uncertainties so severe that they cast significant doubt on the parent's ability to control the subsidiary.

Furthermore, ASC 830-20-30-2 states, in part:

If the lack of exchangeability is other than temporary, the propriety of consolidating, combining, or accounting for the foreign operation by the equity method in the financial statements of the reporting entity shall be carefully considered.

In determining whether foreign exchange restrictions, controls, and other governmentally imposed uncertainties are severe enough to result in a lack of control by a parent entity, a reporting entity must exercise significant judgment and consider factors including, but not limited to, the following:

- Volume restrictions on currency exchange activity (either explicit or in-substance), in conjunction with uncertainties about the reporting entity's or subsidiary's ability to obtain approval for foreign currency exchange through the established exchange mechanisms.
- The ability, currently and historically, to access available legal currency exchange mechanisms in volumes desired or needed by the reporting entity or subsidiary.
- Recent economic developments and trends in the foreign jurisdiction that might affect expectations about the future direction of restrictions on currency exchanges.
- The extent and severity of restrictions imposed by the government on a subsidiary's operations and whether those restrictions demonstrate the reporting entity's inability to control its subsidiary's operations. The reporting entity must use considerable judgment in making this determination since many governments, including the U.S. federal government, require companies to adhere to a framework of laws and regulations that govern operational matters. Examples of government intervention might include restrictions on (1) labor force reductions, (2) decisions about product mix or pricing, and (3) sourcing of raw materials or other inputs into the production process.

We generally believe that the mere fact that currency exchangeability is lacking does not in and of itself create a presumption that a reporting entity should not consolidate its foreign subsidiary, nor does the ability to exchange some volume of currency create such a presumption. In addition, in situations in which government control exists, the reporting entity should consider such control in its VIE assessment when evaluating whether the reporting entity has power. The existence of the above factors represents negative evidence in the determination of whether consolidation is appropriate on the basis of the reporting entity's specific facts and circumstances. At the 2015 AICPA Conference on Current SEC and PCAOB Developments, an SEC staff member, Professional Accounting Fellow Chris Semesky, stated:

In the past year, OCA has observed registrant disclosures indicating a loss of control of subsidiaries domiciled in Venezuela. Disclosures indicate that these conclusions have been premised on judgments about lack of exchangeability being other than temporary and, also in some instances, the severity of government imposed controls. The application of U.S. GAAP in this area requires reasonable judgment to determine when foreign exchange restrictions or government imposed controls or uncertainties are so severe that a majority owner no longer controls a subsidiary. In the same way, a restoration of exchangeability or loosening of government imposed controls may result in the restoration of control and consolidation. In other words, I would expect consistency in a particular registrant's judgments around whether it has lost control or regained control of a subsidiary. In addition, I would expect registrants in these situations to have internal controls over financial reporting that include continuous reassessment of foreign exchange restrictions and the severity of government imposed controls.
Further, to the extent a majority owner concludes that it no longer has a controlling financial interest in a subsidiary as a result of foreign exchange restrictions and/or government imposed controls, careful consideration should be given to whether that subsidiary would be considered a variable interest entity upon deconsolidation because power may no longer reside with the equity-at-risk holders. As a result, registrants should not only think about clear and appropriate disclosure of the judgments around, and the financial reporting impact of, deconsolidation but also of the ongoing disclosures for variable interest entities that are not consolidated.

If a reporting entity ultimately concludes that nonconsolidation of a foreign subsidiary is appropriate, the reporting entity must determine the appropriate date for any deconsolidation, including the appropriate currency exchange rate to use for remeasuring its deconsolidated investment and any other outstanding monetary balances that are no longer eliminated in consolidation (if they are not considered fully impaired). Furthermore, a reporting entity should provide clear disclosure of the basis for its consolidation/nonconsolidation conclusion regarding an investment in a foreign subsidiary for which negative evidence exists about whether it controls the foreign subsidiary. A reporting entity that continues to consolidate may wish to consider disclosing its intention to continue monitoring developments, along with a description of the possible financial statement impact, if estimable, if deconsolidation were to occur. In addition, if a reporting entity concludes that nonconsolidation of a foreign subsidiary is appropriate, the reporting entity should continue to monitor developments each reporting period to determine whether it has regained control and thus should reconsolidate the foreign subsidiary.

**D.3.2.1 Accounting for a Nonconsolidated Foreign Subsidiary Under Foreign Exchange Restrictions and Other Uncertainties**

When a reporting entity does not consolidate a majority-owned foreign subsidiary as a result of foreign exchange restrictions, controls, or other governmentally imposed uncertainties, it should generally use one of the following methods to account for its nonconsolidated subsidiary:

- If the reporting entity exercises significant influence over the subsidiary, it should use the equity method. The reporting entity should carefully consider all relevant facts and circumstances to determine whether it continues to have significant influence over the subsidiary.
- If the reporting entity does not have significant influence, it should account for its investment at fair value or in accordance with the measurement guidance in ASC 321-10-35-2.
- If the reporting entity meets the relevant conditions specified in ASC 205-20 and ASC 360-10-45-5, it should account for the subsidiary as a disposal group.

In many cases, the reporting entity may conclude that given the combination of foreign exchange restrictions and other governmentally imposed uncertainties, it is appropriate to account for the investment in the nonconsolidated subsidiary in accordance with the measurement guidance in ASC 321-10-35-2 (if certain conditions are met).

**D.3.3 Research and Development Arrangements**

ASC 810-30 discusses research and development arrangements in which a sponsor spins off a new company (“Newco”) and then provides Newco with all of the funds for the research and development activities. ASC 810-30-25-3 states that the sponsor should (1) “[r]eclassify the cash contributed to the [Newco] as restricted cash,” (2) “[r]ecognize research and development expense as the research and development activities are performed,” and (3) “[a]ccount for the distribution of the [Newco] common stock as a dividend to common stockholders of the sponsor.” These arrangements would typically provide the sponsor with a call option on Newco’s common stock.
Changing Lanes

As discussed in the Roadmap’s Introduction, the FASB issued a proposed ASU in September 2017 that would reorganize all of the consolidation guidance and move it to a new topic (ASC 812). The amendments in the ASU would eliminate the guidance on research and development in ASC 810-30 since user outreach has indicated that it is not applied in practice. In June 2018, the FASB met to discuss comment letter feedback on the proposed ASU and decided to continue its project on reorganizing ASC 810. As of the date of this publication, this is still an active project. Stakeholders are encouraged to monitor activity at the FASB for any relevant developments.

The scope of ASC 810-30 is specifically limited to those research and development arrangements in which (1) all of the funds for the research and development activities are provided by the sponsor of the research and development arrangement and (2) the legal entity that performs the research and development activities is not a VIE.

Example D-8

An employee of Reporting Entity A announced his intention to leave A and start a new technology company. The individual and three other individuals unrelated to A incorporated a new company, Entity B. Reporting Entity A agreed to effectively act as venture capitalist for B. The founders of B contributed nominal consideration to their start-up venture for B common stock, while A contributed $10 million in exchange for B preferred stock. The terms of the agreement between A and B stipulate that both parties would agree on the plan for developing a new technology but that B would perform the development efforts at its expense, subcontracting any of its obligations only with A’s approval. After delivery of the technology to A, B has the right to put to A, and A has the right to call from B, all outstanding common shares of B. The terms of the put and call are identical and provide for the price of the technology to be fixed on certain dates, with the put and call terminating if the technology is not delivered by the deadline established in the agreement.

This arrangement is not within the scope of ASC 810-30. Key differences between the scenario above and the example in ASC 810-30-55 include the following:

- The formation of the new company is not completed through capitalization of a new entity and a subsequent spin-off.
- The research and development work is completed by the new company and not by the sponsor.
- The put and call are exercisable only if the product is delivered.
- The new company’s operations, except for subcontracting, are not subject to the approval of the sponsor.

D.3.4 Contract-Controlled Entity Model

<table>
<thead>
<tr>
<th>ASC 810-10</th>
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<tr>
<td><strong>15-20</strong> The guidance in the Consolidation of Entities Controlled by Contract Subsections applies, in part, to contractual management arrangements with both of the following characteristics:</td>
</tr>
<tr>
<td>a. Relationships between entities that operate in the health care industry including the practices of medicine, dentistry, veterinary science, and chiropractic medicine (for convenience, entities engaging in these practices are collectively referred to as physician practices)</td>
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<tr>
<td>b. Relationships in which the physician practice management entity does not own the majority of the outstanding voting equity instruments of the physician practice, whether because the physician practice management entity is precluded by law from owning those equity instruments or because the physician practice management entity has elected not to own those equity instruments.</td>
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As stated in the preceding paragraph, there may be industries other than the health care industry in which a contractual management arrangement is established under circumstances similar to those addressed in the Consolidation of Entities Controlled by Contract Subsections.
A physician practice management entity can establish a controlling financial interest in a physician practice through contractual management arrangements. Specifically, a controlling financial interest exists if, for a requisite period of time, the physician practice management entity has control over the physician practice and has a financial interest in the physician practice that meets all six of the requirements listed in the following paragraph. That paragraph contains guidance that describes how those six requirements are to be applied. Paragraph 810-10-55-206 contains a decision tree illustrating the basic analysis called for by both the six requirements and the presumptive, but not the other, interpretive guidance.

If all of the following requirements are met, then the physician practice management entity has a controlling financial interest in the physician practice:

a. Term. The contractual arrangement between the physician practice management entity and the physician practice has both of the following characteristics:
   1. Has a term that is either the entire remaining legal life of the physician practice entity or a period of 10 years or more
   2. Is not terminable by the physician practice except in the case of gross negligence, fraud, or other illegal acts by the physician practice management entity, or bankruptcy of the physician practice management entity.

b. Control. The physician practice management entity has exclusive authority over all decision making related to both of the following:
   1. Ongoing, major, or central operations of the physician practice, except for the dispensing of medical services. This must include exclusive decision-making authority over scope of services, patient acceptance policies and procedures, pricing of services, negotiation and execution of contracts, and establishment and approval of operating and capital budgets. This authority also must include exclusive decision-making authority over issuance of debt if debt financing is an ongoing, major, or central source of financing for the physician practice.
   2. Total practice compensation of the licensed medical professionals as well as the ability to establish and implement guidelines for the selection, hiring, and firing of them.

c. Financial interest. The physician practice management entity must have a significant financial interest in the physician practice that meets both of the following criteria:
   1. Is unilaterally saleable or transferable by the physician practice management entity
   2. Provides the physician practice management entity with the right to receive income, both as ongoing fees and as proceeds from the sale of its interest in the physician practice, in an amount that fluctuates based on the performance of the operations of the physician practice and the change in the fair value thereof.

Under the contract-controlled entity model, a reporting entity should consolidate a legal entity (that is not a VIE) in which it has a controlling financial interest, even if the reporting entity owns little or none of the outstanding equity of the legal entity. To have a controlling financial interest under the contract-controlled entity model, a reporting entity must meet all of the criteria in ASC 810-10-15-22 regarding (1) the term of the contractual arrangement, (2) control over decision-making, and (3) a significant financial interest in the arrangement. The evaluation of control should take into account whether other parties have substantive participating rights.

With the introduction of the VIE model, the relevance of the contract-controlled entity model has diminished. This is because a legal entity that is controlled by contract would most likely be a VIE since one of the conditions for exemption from the VIE model is that the equity investors at risk must control the most significant activities of the legal entity (see Section 5.3). However, in the rare instances in which such a legal entity is not a VIE, the guidance in ASC 810-10-15-20 through 15-22 applies.
While the contract-controlled entity model is typically applied only for specific, limited arrangements in the health care industry (i.e., physical practice management entities), the guidance could potentially apply in other situations, as discussed below. ASC 810-10-25-63 through 25-79 provide additional interpretative guidance on the contract-controlled entity model.

**Changing Lanes**

As discussed in the Roadmap's Introduction, the FASB issued a proposed ASU in September 2017 that would (1) reorganize all of the consolidation guidance and move it to a new topic (ASC 812) and (2) move the guidance related to the contract-controlled entity model that is currently in ASC 810 to ASC 958. Paragraph BC5 of the proposed ASU provides the FASB's thoughts regarding moving the guidance for the contract-controlled entity model. It states, in part:

All of the stakeholders who participated in outreach efforts asserted that they were unaware of instances in which the Consolidation of Entities Controlled by Contract Subsections of Topic 810 were being applied and, if they were, it would have to be by [NFPs]. Intuitively, if a legal entity is controlled by contract and not voting, the legal entity would be a VIE. Because NFPs generally are not within the scope of the VIE guidance, they could be subject to the Consolidation of Entities Controlled by Contract guidance.

In June 2018, the FASB met to discuss comment letter feedback on the proposed ASU and decided to continue its project on reorganizing ASC 810. As of the date of this publication, this is still an active project. Stakeholders are encouraged to monitor activity at the FASB for any relevant developments.

**D.3.4.1 Application to Arrangements Other Than Physician Practice Management Entities**

During deliberations of EITF 97-2, the SEC observer indicated that the conclusions reached (now codified in the Consolidation of Entities Controlled by Contract subsections of ASC 810-10) may apply to similar arrangements in industries other than physician practice management and that the SEC staff considers this guidance when assessing the appropriate accounting for such arrangements.

The SEC observer noted during the deliberations on EITF 97-2 that similar arrangements could include circumstances in which one entity had a controlling financial interest in another entity through either a nominee structure or another contractual arrangement. Examples may include research and development arrangements, franchise arrangements, hotel management contracts, and service corporations for real estate investment trusts, and may involve the transfer of significant rights from the legal owners of an entity to another through a contract. Because these structures appear to be similar to those contemplated in the contract-controlled entity model, it may be appropriate for reporting entities to consult that guidance when assessing whether to consolidate such an entity.

If a management company consolidates the management entity under the contract-controlled entity model, the SEC most likely will look for disclosure of (1) what a controlling financial interest is and (2) how the terms of the management agreement (or nominee shareholder arrangement) give the manager that controlling financial interest. In addition, the registrant's MD&A should describe the impact of this controlling financial interest on the company's business, risks, operations, and accounting.

**D.3.4.2 Application to Joint Ventures**

ASC 810-10-15-22(b)(1) and (b)(2) indicate that for a management entity to hold a controlling financial interest, it must have exclusive authority over all decision making related to significant ordinary-course-of-business actions such as ongoing, major, or central operations of the entity and compensation, selection, hiring, and firing of personnel. In a joint venture arrangement in which both parties must approve significant ordinary-course-of-business actions, neither party has such exclusive authority.
Therefore, in a joint venture in which each investor must approve significant ordinary-course-of-business actions, no investor would consolidate the joint venture (i.e., the contract-controlled entity model would not be applicable).

Example D-9

The law in Country X prohibits foreign majority ownership. For this reason, Company B, which resides in Country Y, owns 50 percent of Joint Venture A, which resides in Country X along with another 50 percent owner, Company C, an independent third party with no expertise in A’s business. Assume that A is not a VIE. Company B has a management and services agreement with A for the entire remaining legal life of the joint venture as long as B continues to own its equity interest in A. This agreement can be terminated only by mutual agreement or because of gross negligence, fraud, or other illegal acts by B. Company B has appointed, and has the continuing right to appoint, the CEO and CFO of A. If B were to withdraw from the arrangement, C could not run the business itself and would have to sell or liquidate A unless it could find another venture partner with funding and expertise similar to B’s. Company A’s board of directors consists of six individuals, three of whom are assigned by B and three by C. The board of directors must approve A’s ordinary-course-of-business operating and capital decisions, including operating and capital budgets.

Although B possesses many of the control elements listed in ASC 810-10-15-22, B does not have the exclusive right to approve operating and capital decisions, including the respective budgets. Company C is thus able to veto certain actions and preclude B from having exclusive decision-making authority over ongoing, major, and central operations. Company B should not consolidate A unless the ability of C to veto actions related to the ongoing, major, and central operations of A is eliminated.

D.3.4.3 SEC Views on Reporting and Disclosure by Physician Practice Management Entities

The SEC staff has said that it would expect revenues and expenses of medical groups to be displayed separately from those of a physician practice management entity either on the face of the income statement or in a footnote to the financial statements.

A physician practice management entity is expected to clearly and accurately describe its business and contractual relationships. It should disclose the following:

- The nature of the entity’s business, including:
  - Contractual agreements and associated rights and limitations.
  - How fees were determined.
  - Specific services provided.
- The entity’s relationship with the care providers, including:
  - Whether physician groups contract directly with the entity (or its assignee) or a managed care company.
  - Who assumes the risk under managed care contracts and, if the entity does, whether there are issues related to medical licensing.
  - Who assumes the risk associated with capitated payment contracts and, if the entity does, whether the entity is subject to regulation as an insurance company.
- State or federal regulations that affect the entity, including:
  - State prohibitions against corporate medical practice.
  - Regulation of the entity as an insurer.
  - The impact of federal anti-kickback and self-referral restrictions.
The SEC staff has said that it expects a physician practice management entity to completely discuss the contractual terms in MD&A, including rights and obligations, the basis for the determination of fees, and the ability of the entity to profitably manage the practices. Further, the staff has noted that the entity is generally not required to provide the financial statements of a medical practice that the entity either has acquired or will acquire as long as the entity will not consolidate or provide any guarantees to the medical practice and is not materially dependent on it.
Appendix E — Industry-Specific Guidance

This appendix discusses considerations related to applying the consolidation requirements in ASC 810 for the following structures and entities:

- Securitization structures (see Section E.1).
- Collateralized investment vehicles (see Section E.2).
- Real estate structures (see Section E.3).
- LIHTC structures (see Section E.4).
- Power and utilities entities (see Section E.5).
- NFP and health care entities (see Section E.6).

E.1 Securitization Structures

E.1.1 Overview

In a securitization transaction, the reporting entity will typically transfer a financial asset (or a portion of a financial asset) to another legal entity (securitization entity). For a financial asset transfer to be accounted for as a sale, the transferor must first consider whether it is required to consolidate the transferee. If the financial asset is transferred to a consolidated subsidiary, control over the transferred financial asset has not been surrendered, and the transaction would not qualify as a sale. Second, even if the transferee is not consolidated, the transferor must surrender control over the asset transferred. Control is considered to be surrendered only if all three of the following conditions are met: (1) the asset has been legally isolated, (2) the transferee has the ability to pledge or exchange the asset, and (3) the transferor otherwise no longer maintains effective control over the asset.

However, as stated in ASC 860-10-55-17D, “if the transferee is a consolidated subsidiary of the transferor (its parent), the transferee shall recognize the transferred financial assets in its separate entity financial statements, unless the nature of the transfer is a secured borrowing with a pledge of collateral.” Accordingly, to prepare stand-alone financial statements of the subsidiary entity, the reporting entity would be required to evaluate whether the transfer between the affiliates meets the conditions to qualify as a sale, ignoring the fact that the entities are under common control.

The discussion below focuses on the consolidation considerations under ASC 810 related to a typical securitization (not on whether a transfer qualifies for sale accounting under ASC 860).
E.1.2 Variable Interests in a Securitization Entity

In its evaluation to determine whether it is required to consolidate a securitization entity, the reporting entity must identify all the parties to the transaction and identify which of those parties has a variable interest. While there is no requirement for the transacting parties to compare their accounting conclusions, each participant needs to understand the rights and obligations of each party involved with the securitization entity to reach a conclusion about its own accounting for its interest in the securitization entity.

E.1.2.1 Beneficial Interests Received

To purchase financial assets from the transferor, the securitization entity will issue securities (beneficial interests) to investors either through a private offering or a public offering. The transferor may retain some or all of the beneficial interests issued by the securitization entity as consideration for the financial assets transferred. As discussed in Section 4.3.2, beneficial interests or debt instruments that represent financing instruments of a legal entity are almost always variable interests, even if the instruments are the most senior in the capital structure of the legal entity. As liabilities, these instruments are designed to absorb variability in the performance of the legal entity’s assets because the beneficial interest holder is exposed to that legal entity’s ability to pay (i.e., credit risk) and may be exposed to interest rate risk, depending on the design of the legal entity.

E.1.2.2 Guarantees

A transferor may also provide credit enhancements to the securitization structure to increase the likelihood that the other investors will receive the cash flows to which they are entitled. Doing so improves the marketability of the beneficial interests issued while the transferor retains the risk of the underlying assets that it transferred to the securitization entity. Since guarantees expose the transferor to expected losses of the transferee, these arrangements are typically variable interests. However, whether such an arrangement is a variable interest depends on the design of the legal entity and the characteristics of that instrument. In addition, when analyzing a guarantee of financial assets in a securitization entity, the transferor must determine whether the specified asset(s) subject to the guarantee have a fair value that is less than half of the total fair value of the securitization entity’s assets. If the specified asset or assets are less than half of the total fair value of the securitization entity’s assets, and the transferor does not have any other interest in the legal entity, the guarantee is not considered a variable interest in the entire legal entity but rather a variable interest in specified assets within the transferee entity (see Section 4.3.11).

E.1.2.3 Fees Paid to Decision Makers or Service Providers

Securitizations involve either a static portfolio of financial assets or a managed portfolio of financial assets. In a static portfolio securitization, the financial assets are held by the securitization entity until they are repaid by the original obligor. In a managed portfolio securitization, an asset manager will actively trade the underlying investments to maximize the returns of the securitization entity.

A servicer or decision maker that has the ability to make investment decisions of the securitization entity will need to evaluate whether its decision-making arrangement represents a variable interest in the securitization entity. If the servicer’s or decision maker’s fee arrangement meets all three conditions in ASC 810-10-55-37, then the arrangement would not be considered a variable interest. If, as is often the case, the servicer also owns some of the beneficial interests issued by the securitization entity, it is likely that the servicer’s or decision maker’s fee arrangement represents a variable interest. In addition, if the fee arrangement exposes the servicer or decision maker to the risk of loss in the transferee, the fee arrangement is a variable interest. However, a servicer or decision maker that does not hold a variable interest in the securitization entity will never consolidate the securitization entity. See Section 4.4 for a discussion of decision-maker and service-provider fees.
E.1.3 Determining Whether a Securitization Entity Is a VIE

Not all SPEs are VIEs, but generally all securitization SPEs are VIEs. A securitization entity usually does not issue equity instruments with voting rights (or other interests with similar rights) that have the power to direct the significant activities of the entity, and often the securitization entity's total equity investment at risk is not sufficient to permit the entity to finance its activities without additional forms of credit enhancement or other subordinated financial support. Because securitization entities are typically insufficiently capitalized, with little or no true “equity” for accounting purposes, and are rarely designed to have a voting equity class that possesses the power to direct the securitization entities' activities, they are generally VIEs. See Chapter 5 for further discussion of determining whether a legal entity is a VIE.

E.1.4 Determining the Primary Beneficiary of a Securitization Entity

ASC 810 requires a reporting entity to identify the primary beneficiary of a securitization entity that is a VIE on the basis of whether the reporting entity has both (1) the power to direct the activities that most significantly affect the VIE's economic performance and (2) the obligation to absorb the VIE's losses or the right to receive benefits from the VIE that could potentially be significant to the VIE. Only one reporting entity is expected to control a securitization entity. Although several deal participants could have variable interests in the securitization entity, typically only one would have the power to direct the activities that most significantly affect the securitization entity's economic performance. See Chapter 7 for further discussion of identifying the primary beneficiary of a VIE.

E.1.4.1 Power Analysis — Identifying the Activities That Most Significantly Affect the VIE

In securitizations, the economic performance of the legal entity is generally most significantly affected by the performance of the underlying assets. Accordingly, the activities that most significantly affect the economic performance of the legal entity are typically the management by the servicer of the delinquencies and defaults that inevitably occur or, in a managed CLO, the activities of the collateral manager related to selecting, monitoring, and disposing of collateral assets. Sometimes, in structures like commercial paper (CP) conduits, the management of liabilities (e.g., selecting the tenor of CP) will also significantly affect the performance of the legal entity, but generally it will not be the most significant activity. Some of the factors that might affect the performance of the underlying assets could be beyond the direct control of any of the parties to the securitization (like voluntary prepayments) and therefore are not considered in the power analysis.

E.1.4.1.1 Situations in Which Securitization Entities Will Not Have Ongoing Activities That Significantly Affect Their Economic Performance

In limited situations, the ongoing activities performed throughout the life of a securitization entity (e.g., administrative activities in certain resecuritization entities, such as Re-REMICs) may not be expected to significantly affect the legal entity's economic performance even though they are necessary for the VIE's continued existence. In such situations, the primary beneficiary determination will need to focus on the activities performed and the decisions made at the VIE's inception as part of the VIE's design, because in these situations the initial design had the most significant effect on the economic performance of the VIE. However, it would not be appropriate to determine the primary beneficiary solely on the basis of decisions made at the VIE's inception as part of the VIE's design when there are ongoing activities that will significantly affect the economic performance of the VIE. See Section 7.2.3.2 for further discussion of legal entities that have no ongoing activities.
E.1.4.2 Economics Analysis — Interests That Could Potentially Be Significant to the VIE

The VIE model indicates that a reporting entity must assess the VIE’s purpose and design when evaluating whether the reporting entity has (1) the obligation to absorb losses of the VIE or (2) the right to receive benefits from the VIE that could potentially be significant to the VIE. This assessment includes a consideration of all risks and associated variability that are absorbed by any of the VIE’s variable interest holders. In most securitization structures, any party with a significant beneficial interest in the securitization entity will meet this criteria because probability is not considered. Accordingly, the consolidation evaluation generally focuses on which of those parties has power over the securitization entity. See Section 7.3.3 for further discussion of when an interest would be considered more than insignificant.

E.1.5 Illustrative Examples

Cases A through F in ASC 810-10-55 below illustrate the application of the consolidation assessment for typical securitization structures.

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**ASC 810-10 [Case A: Commercial Mortgage-Backed Securitization]**

**Case A: Commercial Mortgage-Backed Securitization**

55-96 A VIE is created and financed with $94 of investment grade 7-year fixed-rate bonds (issued in 3 tranches) and $6 of equity. All of the bonds are held by third-party investors. The equity is held by a third party, who is also the special servicer. The equity tranche was designed to absorb the first dollar risk of loss and to receive any residual return from the VIE. The VIE uses the proceeds to purchase $100 of BB-rated fixed-rate commercial mortgage loans with contractual maturities of 7 years from a transferor. The commercial mortgage loans contain provisions that require each borrower to pay the full scheduled interest and principal if the loan is extinguished prior to maturity. The transaction was marketed to potential bondholders as an investment in a portfolio of commercial mortgage loans with exposure to the credit risk associated with the possible default by the borrowers.

55-97 Each month, interest received from all of the pooled loans is paid to the investors in the fixed-rate bonds, in order of seniority, until all accrued interest on those bonds is paid. The same distribution occurs when principal payments are received.

55-98 If there is a shortfall in contractual payments from the borrowers or if the loan collateral is liquidated and does not generate sufficient proceeds to meet payments on all bond classes, the equity tranche and then the most subordinate bond class will incur losses, with further losses impacting more senior bond classes in reverse order of priority.

55-99 The transferor retains the primary servicing responsibilities. The primary servicing activities performed are administrative in nature and include remittance of payments on the loans, administration of escrow accounts, and collections of insurance claims. Upon delinquency or default by the borrower, the responsibility for administration of the loan is transferred from the transferor as the primary servicer to the special servicer. Furthermore, the special servicer, as the equity holder, has the approval rights for budgets, leases, and property managers of foreclosed properties.

55-100 The special servicer is involved in the creation of the VIE and required at the creation date that certain loans, which it deemed to be of high risk, be removed from the initial pool of loans that were going to be purchased by the VIE from the transferor. The special servicer also reviewed the VIE’s governing documents to ensure that the special servicer would be allowed to act quickly and effectively in situations in which a loan becomes delinquent. The special servicer concluded the VIE’s governing documents allowed the special servicer to adequately monitor and direct the performance of the underlying loans.

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55-101 For its services as primary servicer, the transferor earns a fixed fee, calculated as a percentage of the unpaid principal balance on the underlying loans. The special servicer also earns a fixed fee, calculated as a percentage of the unpaid principal balance on the underlying loans. The fees paid to the primary and special servicer are both of the following:

a. Compensation for services provided and commensurate with the level of effort required to provide the services
b. Part of a service arrangement that includes only terms, conditions, or amounts that are customarily present in arrangements for similar services negotiated at arm's length.

No party has the ability to remove the primary servicer or the special servicer.

The following diagram illustrates the scenario described above in the FASB's Case A:

- Transferor/Primary Servicer
- Beneficial Interest Holders (Debt)
- Residual Interest/Special Servicer

Servicing Fee 94% Debt Interest VIE BB-Rated Fixed-Rate Commercial Mortgage Loans 6% Equity Interest Plus Servicing Fee

55-102 To evaluate the facts and circumstances and determine which reporting entity, if any, is the primary beneficiary of a VIE, paragraph 810-10-25-38A requires that a reporting entity determine the purpose and design of the VIE, including the risks that the VIE was designed to create and pass through to its variable interest holders. In making this assessment, the variable interest holders of the VIE determined the following:

a. The primary purposes for which the VIE was created were to provide liquidity to the transferor to originate additional loans and to provide investors with the ability to invest in a pool of commercial mortgage loans.

b. The VIE was marketed to debt investors as a VIE that would be exposed to the credit risk associated with the possible default by the borrowers with respect to principal and interest payments, with the equity tranche designed to absorb the first dollar risk of loss. Additionally, the marketing of the transaction indicated that such risks would be mitigated by subordination of the equity tranche.

c. The VIE is not exposed to prepayment risk because the commercial mortgage loans contain provisions that require the borrower to pay the full scheduled interest and principal if the loan is extinguished prior to maturity.

55-103 The special servicer and the bondholders are the variable interest holders in the VIE. The fees paid to the transferor do not represent a variable interest on the basis of a consideration of the conditions in paragraphs 810-10-55-37 through 55-38. The fees paid to the special servicer represent a variable interest on the basis of a consideration of the conditions in those paragraphs, specifically paragraph 810-10-55-37(c), because of the special servicer holding the equity tranche. If the special servicer was only receiving fees and did not hold the equity tranche and if its related parties did not hold any variable interests in the VIE, then the fees would not be a variable interest.
Paragraph 810-10-25-38B requires that a reporting entity identify which activities most significantly impact the VIE’s economic performance and determine whether it has the power to direct those activities. The economic performance of the VIE is most significantly impacted by the performance of its underlying assets. Thus, the activities that most significantly impact the VIE’s economic performance are the activities that most significantly impact the performance of the underlying assets. The special servicer has the ability to manage the VIE’s assets that are delinquent or in default to improve the economic performance of the VIE. Additionally, the special servicer, as the equity holder, can approve budgets, leases, and property managers on foreclosed property. The special servicing activities are performed only upon delinquency or default of the underlying assets. However, a reporting entity’s ability to direct the activities of a VIE when circumstances arise or events happen constitutes power if that ability relates to the activities that most significantly impact the economic performance of the VIE. A reporting entity does not have to exercise its power in order to have power to direct the activities of a VIE. The special servicer’s involvement in the design of the VIE does not, in isolation, result in the special servicer being the primary beneficiary of the VIE. However, in this situation, that involvement indicated that the special servicer had the opportunity and the incentive to establish arrangements that result in the special servicer being the variable interest holder with the power to direct the activities that most significantly impact the VIE’s economic performance.

The bondholders of the VIE have no voting rights and no other rights that provide them with the power to direct the activities that most significantly impact the VIE’s economic performance.

The activities that the primary servicer has the power to direct are administrative in nature and do not most significantly impact the VIE’s economic performance. In addition, the primary servicer, and its related parties, do not hold a variable interest in the VIE. Thus, the primary servicer cannot be the primary beneficiary of the VIE.

If a reporting entity has the power to direct the activities of a VIE that most significantly impact the VIE’s economic performance, then under the requirements of paragraph 810-10-25-38A, that reporting entity also is required to determine whether it has 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.

The special servicer, for its servicing activities, receives a fixed fee that provides it with the right to receive benefits of the VIE. The fees paid to the special servicer are both of the following:

- Compensation for services provided and commensurate with the level of effort required to provide the services
- Part of a service arrangement that includes only terms, conditions, or amounts that are customarily present in arrangements for similar services negotiated at arm’s length.

Therefore, the fees meet the criteria in paragraph 810-10-25-38H, and they should not be considered for purposes of evaluating the characteristic in paragraph 810-10-25-38A(b). The special servicer, as the equity tranche holder, has the obligation to absorb losses and the right to receive benefits, either of which could potentially be significant to the VIE. As equity tranche holder, the special servicer is the most subordinate tranche and therefore absorbs the first dollar risk of loss and has the right to receive benefits, including the VIE’s actual residual returns, if any.

On the basis of the specific facts and circumstances presented in this Case and the analysis performed, the special servicer would be deemed to be the primary beneficiary of the VIE because:

- It is the variable interest holder with the power to direct the activities of the VIE that most significantly impact the VIE’s economic performance.
- As the equity tranche holder, it has the obligation to absorb losses of the VIE and the right to receive benefits from the VIE, either of which could potentially be significant to the VIE.
Case B: Asset-Backed Collateralized Debt Obligation

55-110 A VIE is created and financed with $90 of AAA-rated fixed-rate debt securities, $6 of BB-rated fixed-rate debt securities, and $4 of equity. All debt securities issued by the VIE are held by third-party investors. The equity tranche is held 35 percent by the manager of the VIE and 65 percent by a third-party investor. The VIE uses the proceeds to purchase a portfolio of asset-backed securities with varying tenors and interest rates.

55-111 The transaction was marketed to potential debt investors as an investment in a portfolio of asset-backed securities with exposure to the credit risk associated with the possible default by the issuers of the asset-backed securities in the portfolio and to the interest rate risk associated with the management of the portfolio. The equity tranche was designed to absorb the first dollar risk of loss related to credit risk and interest rate risk and to receive any residual returns from a favorable change in interest rates or credit risk that affects the proceeds received on the sale of investments in the portfolio.

55-112 The assets of the VIE are managed within the parameters established by the underlying trust documents. The parameters provide the manager with the latitude to manage the VIE’s assets while maintaining an average portfolio rating of single B-plus or higher. If the average rating of the portfolio declines, the VIE’s governing documents require that the manager’s discretion in managing the portfolio be curtailed.

55-113 For its services, the manager earns a base, fixed fee and a performance fee in which it receives a portion of the VIE’s profit above a targeted return. The fees paid to the manager are both of the following:
   a. Compensation for services provided and commensurate with the level of effort required to provide the services
   b. Part of a service arrangement that includes only terms, conditions, or amounts that are customarily present in arrangements for similar services negotiated at arm’s length.

The manager can be removed, without cause (as distinguished from with cause), by a simple majority decision of the AAA-rated debt holders. As the debt of the entity is widely dispersed, no one party has the ability to unilaterally remove the manager. If removal of the manager occurs, the manager will continue to hold a 35 percent equity interest in the VIE.

55-114 The third-party equity investor has rights that are limited to administrative matters.

The following diagram illustrates the scenario described above in the FASB’s Case B:
### ASC 810-10 [Case B, continued]

#### 55-115
To evaluate the facts and circumstances and determine which reporting entity, if any, is the primary beneficiary of a VIE, paragraph 810-10-25-38A requires that a reporting entity determine the purpose and design of the VIE, including the risks that the VIE was designed to create and pass through to its variable interest holders. In making this assessment, the variable interest holders of the VIE determined the following:

- **a.** The primary purposes for which the VIE was created were to provide investors with the ability to invest in a pool of asset-backed securities, to earn a positive spread between the interest that the VIE earns on its portfolio and the interest paid to the debt investors, and to generate management fees for the manager.
- **b.** The transaction was marketed to potential debt investors as an investment in a portfolio of asset-backed securities with exposure to the credit risk associated with the possible default by the issuers of the asset-backed securities in the portfolio and to the interest rate risk associated with the management of the portfolio. Additionally, the marketing of the transaction indicated that such risks would be mitigated by the support from the equity tranche.
- **c.** The equity tranche was designed to absorb the first dollar risk of loss related to credit risk and interest rate risk and to receive any residual returns from a favorable change in interest rates or credit risk that affects the proceeds received on the sale of asset-backed securities in the portfolio.

#### 55-116
The third-party debt investors, the third-party equity investor, and the manager are the variable interest holders in the VIE. The fees paid to the manager also represent a variable interest on the basis of a consideration of the conditions in paragraphs 810-10-55-37 through 55-38, specifically paragraph 810-10-55-37(c), because of the manager holding the equity tranche. If the manager was only receiving fees and did not hold the equity tranche and if its related parties did not hold any variable interests in the VIE, then the fees would not be a variable interest.

#### 55-117
Paragraph 810-10-25-38B requires that a reporting entity identify which activities most significantly impact the VIE's economic performance and determine whether it has the power to direct those activities. The economic performance of the VIE is most significantly impacted by the performance of the VIE's portfolio of assets. Thus, the activities that most significantly impact the VIE's economic performance are the activities that most significantly impact the performance of the portfolio of assets. The manager has the ability to manage the VIE's assets within the parameters of the trust documents. If the average rating of the portfolio declines, the VIE's governing documents require that the manager's discretion in managing the portfolio be curtailed. Although the AAA-rated debt holders can remove the manager without cause, no one party has the unilateral ability to exercise the kick-out rights over the manager. Therefore, such kick-out rights would not be considered in this primary beneficiary analysis.

#### 55-118
The debt holders of the VIE do not have voting rights or other rights that provide them with the power to direct activities that most significantly impact the VIE's economic performance. Although the AAA-rated debt holders can remove the manager without cause, no one party has the unilateral ability to exercise the kick-out rights over the manager.

#### 55-119
The third-party equity investor has the power to direct certain activities. However, the activities that the third-party equity investor has the power to direct are administrative and do not most significantly impact the VIE's economic performance.
ASC 810-10 [Case B, continued]

55-120 If a reporting entity has the power to direct the activities of a VIE that most significantly impact the VIE's economic performance, then under the requirements of paragraph 810-10-25-38A, that reporting entity also is required to determine whether it has 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. The manager, as the 35 percent equity tranche holder, has the obligation to absorb losses and the right to receive benefits. As equity tranche holder, the manager has the most subordinate tranche and therefore absorbs 35 percent of the first dollar risk of loss and has the right to receive 35 percent of any residual benefits. The fees paid to the manager are both of the following:

a. Compensation for services provided and commensurate with the level of effort required to provide the services
b. Part of a service arrangement that includes only terms, conditions, or amounts that are customarily present in arrangements for similar services negotiated at arm's length.

Therefore, the fees meet the criteria in paragraph 810-10-25-38H, and they should not be considered for purposes of evaluating the characteristic in paragraph 810-10-25-38A(b). Through the equity interest, the manager has the obligation to absorb losses of the VIE that could potentially be significant to the VIE and the right to receive benefits from the VIE that could potentially be significant to the VIE.

55-121 On the basis of the specific facts and circumstances presented in this Case and the analysis performed, the manager would be deemed to be the primary beneficiary of the VIE because:

a. It is the variable interest holder with the power to direct the activities of the VIE that most significantly impact the VIE's economic performance (and no single entity has the unilateral ability to exercise kick-out rights).

b. Through its equity interest, it has the obligation to absorb losses of the VIE that could potentially be significant to the VIE and the right to receive benefits from the VIE that could potentially be significant to the VIE.

ASC 810-10 [Case C: Structured Investment Vehicle]

Case C: Structured Investment Vehicle

55-122 A VIE is created and financed with $94 of AAA-rated fixed-rate short-term debt with a 6-month maturity and $6 of equity. The VIE uses the proceeds to purchase a portfolio of floating-rate debt with an average life of four years and varying interest rates and short-term deposits with highly rated banks. The short-term debt securities and equity are held by multiple third-party investors. Upon maturity of the short-term debt, the VIE will either refinance the debt with existing investors or reissue the debt to new investors at existing market rates.

55-123 The primary purpose of the VIE is to generate profits by maximizing the spread it earns on its asset portfolio and its weighted-average cost of funding. The transaction was marketed to potential debt investors as an investment in a portfolio of high-quality debt with exposure to the credit risk associated with the possible default by the issuers of the debt in the portfolio. The equity tranche is designed to absorb the first dollar risk of loss related to credit, liquidity, changes in fair value, and interest rate risk and to receive any benefit from a favorable change in credit, changes in fair value, and interest rates.

55-124 The VIE is exposed to liquidity risk because the average tenor of the assets is greater than its liabilities. To mitigate liquidity risk, the VIE maintains a certain portion of its assets in short-term deposits with highly rated banks. The VIE has not entered into a liquidity facility to further mitigate liquidity risk.
ASC 810-10 [Case C, continued]

55-125 The sponsor of the VIE was significantly involved with the creation of the VIE. The sponsor performs various functions to manage the operations of the VIE, which include:

a. Investment management — This management must adhere to the investment guidelines established at inception of the VIE. These guidelines include descriptions of eligible investments and requirements regarding the composition of the credit portfolio (including limits on country risk exposures, diversification limits, and ratings requirements).

b. Funding management — This function provides funding management and operational support in relation to the debt issued and the equity with the objective of minimizing the cost of borrowing, managing interest rate and liquidity risks, and managing the capital adequacy of the VIE.

c. Defeasance management — An event of defeasance occurs upon the failure of the rating agencies to maintain the ratings of the debt securities issued by the VIE at or above certain specified levels. In the event of defeasance, the sponsor is responsible for overseeing the orderly liquidation of the investment portfolio and the orderly discharge of the VIE's obligations. This includes managing the market and credit risks of the portfolio.

55-126 For its services, the sponsor receives a fixed fee, calculated as an annual percentage of the aggregate equity outstanding, and a performance-based fee, calculated as a percentage of the VIE's profit above a targeted return. The fees paid to the sponsor are both of the following:

a. Compensation for services provided and commensurate with the level of effort required to provide the services

b. Part of a service arrangement that includes only terms, conditions, or amounts that are customarily present in arrangements for similar services negotiated at arm's length.

55-127 The debt security holders of the VIE have no voting rights. The equity holders have limited voting rights that are typically limited to voting on amendments to the constitutional documents of the VIE.

The following diagram illustrates the scenario described above in the FASB's Case C:
55-128 To evaluate the facts and circumstances and determine which reporting entity, if any, is the primary beneficiary of a VIE, paragraph 810-10-25-38A requires that a reporting entity determine the purpose and design of the VIE, including the risks that the VIE was designed to create and pass through to its variable interest holders. In making this assessment, the variable interest holders of the VIE determined the following:

a. The primary purposes for which the VIE was created were to provide investors with the ability to invest in a pool of high-quality debt, to maximize the spread it earns on its asset portfolio over its weighted-average cost of funding, and to generate management fees for the sponsor.

b. The transaction was marketed to potential debt investors as an investment in a portfolio of high-quality debt with exposure to the credit risk associated with the possible default by the issuers of the debt in the portfolio.

c. The equity tranche is negotiated to absorb the first dollar risk of loss related to credit, liquidity, fair value, and interest rate risk and to receive a portion of the benefit from a favorable change in credit, fair value, and interest rates.

d. The principal risks to which the VIE is exposed include credit, interest rate, and liquidity risk.

55-129 The third-party debt investors, the third-party equity investors, and the sponsor are the variable interest holders in the VIE. The fees paid to the sponsor represent a variable interest on the basis of a consideration of the conditions in paragraphs 810-10-55-37 through 55-38, specifically paragraph 810-10-55-37(c), because of the sponsor having an implicit variable interest in the VIE as discussed in paragraph 810-10-55-132. If the sponsor was only receiving fees and did not have the implicit variable interest and if its related parties did not hold any variable interests in the VIE, then the fees would not be a variable interest.

55-130 Paragraph 810-10-25-38B requires that a reporting entity identify which activities most significantly impact the VIE’s economic performance and determine whether it has the power to direct those activities. The economic performance of the VIE is significantly impacted by the performance of the VIE’s portfolio of assets and by the terms of the short-term debt. Thus, the activities that significantly impact the VIE’s economic performance are the activities that significantly impact the performance of the portfolio of assets and the terms of the short-term debt (when the debt is refinanced or reissued). The sponsor manages the VIE’s investment, funding, and defeasance activities. The fact that the sponsor was significantly involved with the creation of the VIE does not, in isolation, result in the sponsor being the primary beneficiary of the VIE. However, the fact that the sponsor was involved with the creation of the VIE indicated that the sponsor had the opportunity and the incentive to establish arrangements that result in the sponsor being the variable interest holder with the power to direct the activities that most significantly impact the VIE’s economic performance.

55-131 The debt security holders of the VIE have no voting rights and no other rights that provide them with the power to direct the activities that most significantly impact the VIE’s economic performance. Although the equity holders have voting rights, they are limited to voting on amendments to the constitutional documents of the VIE, and those rights do not provide the equity holders with the power to direct the activities that most significantly impact the VIE’s economic performance.

55-132 If a reporting entity has the power to direct the activities of a VIE that most significantly impact the VIE’s economic performance, then under the requirements of paragraph 810-10-25-38A, that reporting entity also is required to determine whether it has 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. The sponsor considered whether it had an implicit financial responsibility to ensure that the VIE operates as designed. Based on paragraphs 810-10-25-51 and 810-10-25-54, the sponsor determined that it has an implicit financial responsibility and that such obligation requires the sponsor to absorb losses that could potentially be significant to the VIE. This determination was influenced by the sponsor’s concern regarding the risk to its reputation in the marketplace if the VIE did not operate as designed. The fees paid to the sponsor are both of the following:

a. Compensation for services provided and commensurate with the level of effort required to provide the services

b. Part of a service arrangement that includes only terms, conditions, or amounts that are customarily present in arrangements for similar services negotiated at arm’s length.

Therefore, the fees meet the criteria in paragraph 810-10-25-38H, and they should not be considered for purposes of evaluating the characteristic in paragraph 810-10-25-38A(b).
ASC 810-10 [Case C, continued]

55-133 On the basis of the specific facts and circumstances presented in this Case and the analysis performed, the sponsor would be deemed to be the primary beneficiary of the VIE because:

a. It is the variable interest holder with the power to direct the activities of the VIE that most significantly impact the VIE's economic performance.

b. Through its implicit financial responsibility to ensure that the VIE operates as designed, it has the obligation to absorb losses of the VIE that could potentially be significant to the VIE.

ASC 810-10 [Case D: Commercial Paper Conduit]

Case D: Commercial Paper Conduit

55-134 A VIE is created by a reporting entity (the sponsor) and financed with $98 of AAA-rated fixed-rate short-term debt with a 3-month maturity and $2 of subordinated notes. The VIE uses the proceeds to purchase a portfolio of medium-term assets with average tenors of three years. The asset portfolio is obtained from multiple sellers. The short-term debt and subordinated notes are held by multiple third-party investors. Upon maturity of the short-term debt, the VIE will either refinance the debt with existing investors or reissue the debt to new investors.

55-135 The sponsor of the VIE provides credit enhancement in the form of a letter of credit equal to 5 percent of the VIE's assets and it provides a liquidity facility to fund the cash flow shortfalls on 100 percent of the short-term debt. Cash flow shortfalls could arise due to a mismatch between collections on the underlying assets of the VIE and payments due to the short-term debt holders or to the inability of the VIE to refinance or reissue the short-term debt upon maturity.

55-136 A credit default of the VIE's assets resulting in deficient cash flows is absorbed as follows:

a. First by the subordinated note holders
b. Second by the sponsor's letter of credit
c. Third by the short-term debt holders.

The sponsor's liquidity facility does not advance against defaulted assets.

55-137 The VIE is exposed to liquidity risk because the average life of the assets is greater than that of its liabilities. The VIE enters into a liquidity facility with the sponsor to mitigate liquidity risk.

55-138 The transaction was marketed to potential debt investors as an investment in a portfolio of highly rated medium-term assets with minimal exposure to the credit risk associated with the possible default by the issuers of the assets in the portfolio. The subordinated notes were designed to absorb the first dollar risk of loss related to credit. The VIE is marketed to all investors as having a low probability of credit exposure due to the nature of the assets obtained. Furthermore, the VIE is marketed to the short-term debt holders as having protection from liquidity risk due to the liquidity facility provided by the sponsor.

55-139 The sponsor of the VIE performs various functions to manage the operations of the VIE. Specifically, the sponsor:

a. Establishes the terms of the VIE
b. Approves the sellers permitted to sell to the VIE
c. Approves the assets to be purchased by the VIE
d. Makes decisions regarding the funding of the VIE including determining the tenor and other features of the short-term debt issued
e. Administers the VIE by monitoring the assets, arranging for debt placement, compiling monthly reports, and ensuring compliance with the VIE's credit and investment policies.
For providing the letter of credit, liquidity facility, and management services, the sponsor receives fixed fees that are calculated as an annual percentage of the asset value. The short-term debt holders and subordinated note holders have no voting rights. The fees paid to the sponsor for its management services are both of the following:

a. Compensation for services provided and commensurate with the level of effort required to provide the services
b. Part of a service arrangement that includes only terms, conditions, or amounts that are customarily present in arrangements for similar services negotiated at arm's length.

To evaluate the facts and circumstances and determine which reporting entity, if any, is the primary beneficiary of a VIE, paragraph 810-10-25-38A requires that a reporting entity determine the purpose and design of the VIE, including the risks that the VIE was designed to create and pass through to its variable interest holders. In making this assessment, the variable interest holders of the VIE determined the following:

a. The primary purposes for which the VIE was created were to provide investors with the ability to invest in a pool of highly rated medium-term assets, to provide the multiple sellers to the VIE with access to lower-cost funding, to earn a positive spread between the interest that the VIE earns on its asset portfolio and its weighted-average cost of funding, and to generate fees for the sponsor.

b. The transaction was marketed to potential debt investors as an investment in a portfolio of highly rated medium-term assets with minimal exposure to the credit risk associated with the possible default by the issuers of the assets in the portfolio. The subordinated debt is designed to absorb the first dollar risk of loss related to credit and interest rate risk. The VIE is marketed to all investors as having a low probability of credit loss due to the nature of the assets obtained. Furthermore, the VIE is marketed to the short-term debt holders as having protection from liquidity risk due to the liquidity facility provided by the sponsor.

c. The principal risks to which the VIE is exposed include credit, interest rate, and liquidity.

The short-term debt holders, the third-party subordinated note holders, and the sponsor are the variable interest holders in the VIE. The letter of credit and liquidity facility provided by the sponsor protect holders of other variable interests from suffering losses of the VIE. Therefore, the sponsor’s fees for the letter of credit and liquidity facility are not eligible for the evaluation in paragraph 810-10-55-37 and are variable interests in the VIE. The fees paid to the sponsor for its management services represent a variable interest on the basis of a consideration of the conditions in paragraphs 810-10-55-37 through 55-38, specifically paragraph 810-10-55-37(c), because of the sponsor providing the letter of credit and liquidity facility and the fees for the letter of credit and liquidity facility. If the sponsor was only receiving management fees, did not provide the letter of credit and liquidity facility, and did not receive fees for the letter of credit and liquidity facility and if its related parties did not hold any variable interests in the VIE, then the management fees would not be a variable interest.
Paragraph 810-10-25-38B requires that a reporting entity identify which activities most significantly impact the VIE’s economic performance and determine whether it has the power to direct those activities. The economic performance of the VIE is significantly impacted by the performance of the VIE’s portfolio of assets and by the terms of the short-term debt. Thus, the activities that significantly impact the VIE’s economic performance are the activities that significantly impact the performance of the portfolio of assets and the terms of the short-term debt (when the debt is refinanced or reissued). The sponsor manages the operations of the VIE. Specifically, the sponsor establishes the terms of the VIE, approves the sellers permitted to sell to the VIE, approves the assets to be purchased by the VIE, makes decisions about the funding of the VIE including determining the tenor and other features of the short-term debt issued, and administers the VIE by monitoring the assets, arranging for debt placement, and ensuring compliance with the VIE’s credit and investment policies. The fact that the sponsor was significantly involved with the creation of the VIE does not, in isolation, result in the sponsor being the primary beneficiary of the VIE. However, the fact that the sponsor was involved with the creation of the VIE may indicate that the sponsor had the opportunity and the incentive to establish arrangements that result in the sponsor being the variable interest holder with the power to direct the activities that most significantly impact the VIE’s economic performance.

The short-term debt holders and subordinated note holders of the VIE have no voting rights and no other rights that provide them with power to direct the activities that most significantly impact the VIE’s economic performance.

If a reporting entity has the power to direct the activities of a VIE that most significantly impact the VIE’s economic performance, then under the requirements of paragraph 810-10-25-38A, that reporting entity also is required to determine whether it has 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. The fees paid to the sponsor for its management services are both of the following:

a. Compensation for services provided and commensurate with the level of effort required to provide the services
b. Part of a service arrangement that includes only terms, conditions, or amounts that are customarily present in arrangements for similar services negotiated at arm’s length.

Therefore, the management fees meet the criteria in paragraph 810-10-25-38H, and they should not be considered for purposes of evaluating the characteristic in paragraph 810-10-25-38A(b). However, the sponsor still, through its letter of credit and liquidity facility fees, receives benefits from the VIE that could potentially be significant to the VIE. The sponsor, through its letter of credit and liquidity facility, also has the obligation to absorb losses of the VIE that could potentially be significant to the VIE.

On the basis of the specific facts and circumstances presented in this Case and the analysis performed, the sponsor would be deemed to be the primary beneficiary of the VIE because:

a. It is the variable interest holder with the power to direct the activities of the VIE that most significantly impact the VIE’s economic performance.
b. Through its letter of credit and liquidity facility, the sponsor has the obligation to absorb losses that could potentially be significant to the VIE, and, through its fees for the letter of credit and liquidity facility, the sponsor has the right to receive benefits that could potentially be significant to the VIE.

A VIE is created and financed with $100 of a single class of investment-grade 30-year fixed-rate debt securities. The VIE uses the proceeds to purchase $100 of 30-year fixed-rate residential mortgage loans from the transferor. The VIE enters into a guarantee facility that absorbs 100 percent of the credit losses incurred on the VIE’s assets. The assets acquired by the VIE are underwritten by the transferor in accordance with the parameters established by the guarantor. Additionally, all activities of the VIE are prespecified by the trust agreement and servicing guide, which are both established by the guarantor. No critical decisions are generally required for the VIE unless default of an underlying asset is reasonably foreseeable or occurs.
The transaction was marketed to potential debt security holders as an investment in a portfolio of residential mortgage loans with exposure to the credit risk of the guarantor and to the prepayment risk associated with the underlying loans of the VIE. Each month, the security holders receive interest and principal payments in proportion to their percentage ownership of the underlying loans.

If there is a shortfall in contractually required loan payments from the borrowers or if the loan is foreclosed on and the liquidation of the underlying property does not generate sufficient proceeds to meet the required payments on all securities, the guarantor will make payments to the debt securities holders to ensure timely payment of principal and accrued interest on the debt securities.

The guarantor also serves as the master servicer for the VIE. As master servicer, the guarantor services the securities issued by the VIE. Generally, if a mortgage loan is 120 days (or 4 consecutive months) delinquent, and if other circumstances are met, the guarantor has the right to buy the loan from the VIE. The master servicer can only be removed for a material breach in its obligations. As compensation for the guarantee and services provided, the guarantor receives a fee that is calculated monthly as a percentage of the unpaid principal balance on the underlying loans.

As master servicer, the guarantor also is responsible for supervising and monitoring the servicing of the residential mortgage loans (primary servicing). The VIE’s governing documents provide that the guarantor is responsible for the primary servicing of the loans; however, the guarantor is allowed to, and does, hire the transferor to perform primary servicing activities that are conducted under the supervision of the guarantor. The guarantor monitors the primary servicer’s performance and has the right to remove the primary servicer at any time it considers such a removal to be in the best interest of the security holders.

The primary servicing activities are performed under the servicing guide established by the guarantor. Examples of the primary servicing activities include collecting and remitting principal and interest payments, administering escrow accounts, and managing default. When a loan becomes delinquent or it is reasonably foreseeable of becoming delinquent, the primary servicer can propose a default mitigation strategy in which the guarantor can approve, reject, or require another course of action if it considers such action is in the best interest of the security holders. As compensation for servicing the underlying loans, the transferor receives a fee that is calculated monthly as a percentage of the unpaid principal balance on the underlying loans.

The following diagram illustrates the scenario described above in the FASB’s Case E:
To evaluate the facts and circumstances and determine which reporting entity, if any, is the primary beneficiary of a VIE, paragraph 810-10-25-38A requires that a reporting entity determine the purpose and design of the VIE, including the risks that the VIE was designed to create and pass through to its variable interest holders. In making this assessment, the variable interest holders of the VIE determined the following:

a. The primary purposes for which the VIE was created were to provide investors with the ability to invest in a pool of residential mortgage loans with a third-party guarantee for 100 percent of the principal and interest payments due on the mortgage loans in the VIE, to provide the transferor to the VIE with access to liquidity for its originated loans and an ongoing servicing fee, and to generate fees for the guarantor.

b. The transaction was marketed to potential debt security holders as an investment in a portfolio of residential mortgage loans with exposure to the credit risk of the guarantor and prepayment risk associated with the underlying assets of the VIE.

c. The principal risks to which the VIE is exposed include credit risk of the underlying assets, prepayment risk, and the risk of fluctuations in the value of the underlying real estate. The credit risk of the underlying assets and the risk of fluctuations in the value of the underlying real estate are fully absorbed by the guarantor.

The debt securities holders and the guarantor are the variable interest holders in the VIE. The fees paid to the transferor do not represent a variable interest on the basis of a consideration of the conditions in paragraphs 810-10-55-37 through 55-38. The guarantee arrangement protects holders of other variable interests from suffering losses in the VIE because the guarantor is required to fully absorb the credit risk of the underlying assets of the VIE and the risk of fluctuations in the value of the underlying real estate. Therefore, the guarantor's fees are not eligible for the evaluation in paragraph 810-10-55-37.

Paragraph 810-10-25-38B requires that a reporting entity identify which activities most significantly impact the VIE's economic performance and determine whether it has the power to direct those activities. The economic performance of the VIE is most significantly impacted by the performance of its underlying assets. Thus, the activities that most significantly impact the VIE's economic performance are the activities that most significantly impact the performance of the underlying assets. The guarantor, who is also the master servicer, has the ability (through establishment of the servicing terms, to appoint and remove the primary servicer, to direct default mitigation, and to purchase defaulted assets) to manage the VIE's assets that become delinquent (or may become delinquent in the reasonably foreseeable future) to improve the economic performance of the VIE.

Prepayment risk is also a risk that the VIE was designed to create and pass through. However, no variable interest holder has the power to direct activities related to such risk.

Because the guarantor is able to appoint and replace the primary servicer and direct default mitigation, the primary servicer does not have the power to direct the activities that most significantly impact the VIE's economic performance. In addition, the primary servicer and its related parties do not hold a variable interest in the VIE. Thus, the primary servicer cannot be the primary beneficiary of the VIE. Furthermore, the security holders have no voting rights and, thus, no power to direct the activities that most significantly impact the VIE's economic performance.

If a reporting entity has the power to direct the activities of a VIE that most significantly impact the VIE's economic performance, then under the requirements of paragraph 810-10-25-38A, that reporting entity also is required to determine whether it has 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. The guarantor, through its fee arrangement, receives benefits, which may or may not potentially be significant under this analysis; however, the guarantor has the obligation to absorb losses of the VIE that could potentially be significant through its guarantee obligation. Therefore, the fees are not eligible for the evaluation in paragraph 810-10-25-38H, and they should be considered for purposes of evaluating the characteristic in paragraph 810-10-25-38A(b).
On the basis of the specific facts and circumstances presented in this Case and the analysis performed, the guarantor would be deemed to be the primary beneficiary of the VIE because:

a. It is the variable interest holder with the power to direct the activities of the VIE that most significantly impact the VIE’s economic performance.
b. Through its guarantee, it has the obligation to absorb losses of the VIE that could potentially be significant to the VIE.

A VIE is created and financed with $100 of 30-year fixed-rate debt securities. The securities are issued in 2 tranches (a $90 senior tranche and a $10 residual tranche). The senior tranche securities are investment grade and are widely dispersed among third-party investors. The residual tranche securities are held by the transferor. The VIE uses the proceeds to purchase $100 of 30-year fixed-rate residential mortgage loans from a transferor. A default on the underlying loans is absorbed first by the residual tranche held by the transferor. All activities of the VIE are prespecified by a pooling and servicing agreement for the transaction. No critical decisions are generally required for the VIE unless default of an underlying asset is reasonably foreseeable or occurs.

The transaction was marketed to potential senior debt security holders as an investment in a portfolio of residential mortgage loans with exposure to the credit risk of the underlying loan borrowers and to the prepayment risk associated with the underlying loans of the VIE. Each month the security holders receive interest and principal payments in proportion to their percentage of ownership of the underlying loans. The residual tranche was designed to provide a credit enhancement to the transaction and to absorb the first dollar risk of loss related to credit.

The primary servicing responsibilities are retained by the transferor. No party has the ability to remove the transferor as servicer.

The servicing activities are performed in accordance with the pooling and servicing agreement. Examples of the servicing activities include collecting and remitting principal and interest payments, administering escrow accounts, monitoring overdue payments, and overall default management. Default management includes evaluating the borrower’s financial condition to determine which loss mitigation strategy (specified in the pooling and servicing agreement) will maximize recoveries on a particular loan. The acceptable default management strategies are limited to the actions specified in the pooling and servicing agreement and include all of the following:

a. Modifying the terms of loans when default is reasonably foreseeable
b. Temporary forbearance on collections of principal and interest (such amounts would be added to the unpaid balance on the loan)
c. Short sales in which the servicer allows the underlying borrower to sell the mortgaged property even if the anticipated sale price will not permit full recovery of the contractual loan amounts.

As compensation for servicing the underlying loans, the transferor receives a fee, calculated monthly as a percentage of the unpaid principal balance on the underlying loans. Although the servicing activities, particularly managing default, are required to be performed in accordance with the pooling and servicing agreement, the transferor, as servicer, has discretion in determining which strategies within the pooling and servicing agreement to utilize to attempt to maximize the VIE’s economic performance. The fees paid to the transferor are both of the following:

a. Compensation for services provided and commensurate with the level of effort required to provide those services
b. Part of a service arrangement that includes only terms, conditions, or amounts that are customarily present in arrangements for similar services negotiated at arm’s length.
The following diagram illustrates the scenario described above in the FASB’s Case F:

![Diagram of the scenario described above in the FASB’s Case F.]

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**ASC 810-10 [Case F, continued]**

55-165 To evaluate the facts and circumstances and determine which reporting entity, if any, is the primary beneficiary of a VIE, paragraph 810-10-25-38A requires that a reporting entity determine the purpose and design of the VIE, including the risks that the VIE was designed to create and pass through to its variable interest holders. In making this assessment, the variable interest holders of the VIE determined the following:

a. The primary purposes for which the VIE was created were to provide investors with the ability to invest in a pool of residential mortgage loans and to provide the transferor to the VIE with access to liquidity for its originated loans and an ongoing servicing fee and potential residual returns.

b. The transaction was marketed to potential senior debt security holders as an investment in a portfolio of residential mortgage loans with credit enhancement provided by the residual tranche and prepayment risk associated with the underlying assets of the VIE. The marketing of the transaction indicated that credit risk would be mitigated by the subordination of the residual tranche.

c. The principal risks to which the VIE is exposed include credit of the underlying assets, prepayment risk, and the risk of fluctuations in the value of the underlying real estate.

55-166 The debt security holders and the transferor are the variable interest holders in the VIE. The fee paid to the transferor (in its role as servicer) represents a variable interest on the basis of a consideration of the conditions in paragraphs 810-10-55-37 through 55-38, specifically paragraph 810-10-55-37(c), because of the transferor holding the residual tranche. If the transferor was only receiving fees and did not hold the residual tranche and if its related parties did not hold any variable interests in the VIE, then the fees would not be a variable interest.

55-167 Paragraph 810-10-25-38B requires that a reporting entity identify which activities most significantly impact the VIE’s economic performance and determine whether it has the power to direct those activities. The economic performance of the VIE is most significantly impacted by the performance of its underlying assets. Thus, the activities that most significantly impact the VIE’s economic performance are the activities that most significantly impact the performance of the underlying assets. The transferor, as servicer, has the ability to manage the VIE’s assets that become delinquent (or are reasonably foreseeable of becoming delinquent) to improve the economic performance of the VIE. Additionally, no party can remove the transferor in its role as servicer. The default management activities are performed only after default of the underlying assets or when default is reasonably foreseeable. However, a reporting entity’s ability to direct the activities of a VIE when circumstances arise or events happen constitutes power if that ability relates to the activities that most significantly impact the economic performance of the VIE. A reporting entity does not have to exercise its power in order to have power to direct the activities of a VIE.

55-168 Prepayment risk is also a risk that the VIE was designed to create and pass through. However, no variable interest holder has the power to direct matters related to such risk.

55-169 The senior security holders have no voting rights and, thus, no power to direct the activities that most significantly impact the VIE’s economic performance.
55-170 If a reporting entity has the power to direct the activities of a VIE that most significantly impact the VIE's economic performance, then under the requirements of paragraph 810-10-25-38A, that reporting entity also is required to determine whether it has 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. The transferor, through its residual tranche ownership, has the obligation to absorb losses and the right to receive benefits, either of which could potentially be significant to the VIE. The fees paid to the transferor are both of the following:

a. Compensation for services provided and commensurate with the level of effort required to provide those services
b. Part of a service arrangement that includes only terms, conditions, or amounts that are customarily present in arrangements for similar services negotiated at arm's length.

Therefore, the fees meet the criteria in paragraph 810-10-25-38H and should not be considered for purposes of evaluating the characteristic in paragraph 810-10-25-38A(b).

55-171 On the basis of the specific facts and circumstances presented in this Case and the analysis performed, the transferor would be deemed to be the primary beneficiary of the VIE because:

a. It is the variable interest holder with the power to direct the activities of the VIE that most significantly impact the VIE's economic performance.

b. Through its residual tranche ownership, it has the obligation to absorb losses and the right to receive benefits, either of which could potentially be significant to the VIE.

### E.2 Collateralized Investment Vehicles

#### E.2.1 Consolidation Analysis

Collateralized investment vehicles (CIVs) are unique securitizations in that there is typically no transfer of assets from the sponsor to the securitization entity. Instead, the CIV purchases financial assets (e.g., senior syndicated loans) from the open market by using proceeds from a warehouse line (warehousing phase). Once the legal entity has accumulated loans of a quantity sufficient to permit securitization, it will issue beneficial interests and use the proceeds from the sale of its securities to pay off the warehouse line and purchase any remaining financial assets needed (securitization phase). Common examples of CIVs include CLOs and CDOs. A CIV is an example of a CFE, as defined in ASC 810.

A CIV employs a collateral manager (typically a bank or an investment manager that sponsors the CIV) that performs various functions for the CIV during its different stages. For example, during the initial warehousing phase, the collateral manager is responsible for acquiring the assets for the CIV and ensuring that the asset composition complies with the transaction documents. During the securitization phase, the collateral manager is responsible for determining the appropriate action to take in response to a default or other event as well as how to reinvest the principal proceeds received from the underlying loans.

Because a substantive contingent event may need to be resolved (e.g., market receptivity to the securitization or consent granted by all parties involved) before the CIV’s transition from the warehousing phase to the securitization phase, a separate consolidation analysis may need to be performed for each distinct phase. That is, because its securitization may be considered a fundamental redesign of the CIV, there may be different activities that most significantly affect the potential VIE’s economic performance during each phase.
E.2.2 Determining Whether a CIV Is a VIE

A reporting entity is required to apply either the VIE model or the voting interest entity model in performing its consolidation assessment. To determine which model to use, the collateral manager must decide whether any of the following conditions apply:

- The CIV has insufficient equity at risk to finance its activities.
- The at-risk equity holders (as a group) lack any of the three characteristics of a controlling financial interest.
- Members of the at-risk equity group have nonsubstantive voting rights.

If any of these conditions apply, the CIV should be evaluated under the VIE model.

Although a CIV may issue equity interests that provide credit support to the legal entity’s senior investors, the tranched capital structure of the CIV, as well as the multiple series of debt instruments typically issued by a CIV, will usually serve as qualitative evidence that the legal entity has insufficient equity at risk.

Even if a CIV has sufficient equity investment at risk, the equity interests do not typically have voting rights that give those investors power to direct the activities of the legal entity. Rather, the decision-making ability is typically granted to the collateral manager, and the ability to remove the collateral manager is often shared with holders of debt interests issued by the CIV. Unless a single equity holder with equity at risk has the unilateral ability to remove the collateral manager, or the collateral manager is acting as an agent on behalf of the at-risk equity group, through its equity investment at risk (i.e., the decision-making rights are not considered a variable interest), the CIV would be a VIE. See Chapter 5 for further discussion of whether a legal entity is a VIE.
E.2.3 Determining the Primary Beneficiary of a CIV

The chart below illustrates the steps a collateral manager would take in determining whether it is required to consolidate a CIV. The sections that follow the chart discuss the steps in detail.

1 A collateral manager must also assess whether it would be required to perform the related-party tiebreaker test (see step 4 for additional details).
**E.2.3.1 Step 1: Does the Collateral Manager Have a Variable Interest in the CIV?**

<table>
<thead>
<tr>
<th>ASC 810-10</th>
</tr>
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<tbody>
<tr>
<td>55-37 Fees paid to a legal entity’s decision maker(s) or service provider(s) are not variable interests if all of the following conditions are met:</td>
</tr>
<tr>
<td>a. The fees are compensation for services provided and are commensurate with the level of effort required to provide those services.</td>
</tr>
<tr>
<td>b. Subparagraph superseded by Accounting Standards Update No. 2015-02.</td>
</tr>
<tr>
<td>c. The decision maker or service provider does not hold other interests in the VIE that individually, or in the aggregate, would absorb more than an insignificant amount of the VIE’s expected losses or receive more than an insignificant amount of the VIE’s expected residual returns.</td>
</tr>
<tr>
<td>d. The service arrangement includes only terms, conditions, or amounts that are customarily present in arrangements for similar services negotiated at arm’s length.</td>
</tr>
<tr>
<td>e. Subparagraph superseded by Accounting Standards Update No. 2015-02.</td>
</tr>
<tr>
<td>f. Subparagraph superseded by Accounting Standards Update No. 2015-02.</td>
</tr>
</tbody>
</table>

In accordance with ASC 810-10-55-37, the evaluation of whether fees paid to a collateral manager are a variable interest focuses on (1) whether the fees “are commensurate with the level of effort” (criterion (a)), (2) whether the collateral manager has any other direct or indirect interests (including indirect interests through its related parties and certain interests held by its related parties under common control) that absorb more than an insignificant amount of the CIV’s variability (criterion (c)), and (3) whether the arrangement’s terms are customary (criterion (d)).

When a collateral manager evaluates its economic exposure to a VIE (criterion (c)), it should consider its direct interests in the CIV together with its indirect interests held through its related parties (or de facto agents) on a proportionate basis unless the related party is under common control with the collateral manager. For example, if a collateral manager owns a 20 percent interest in a related party that is not under common control and that related party owns 40 percent of the residual tranche of the CIV being evaluated, the collateral manager’s interest would be considered equivalent to an 8 percent direct interest in the residual tranche of the CIV.

By contrast, if a collateral manager has an indirect interest in a CIV through a related party that is under common control (i.e., the collateral manager holds a direct variable interest in the related party under common control), it must include the related party’s entire interest in its evaluation of its economic exposure to determine whether it has a variable interest in the CIV rather than just its proportionate share. (However, in the assessment of whether the reporting entity meets the economics criterion in the primary-beneficiary determination, the guidance on entities under common control is consistent with the proportionate-basis guidance that applies to other related parties. See Section 7.3.5.1 for additional information.) In situations in which the collateral manager does not hold an interest in the related party under common control, the collateral manager would exclude the related party’s interest unless the interest was provided to the related party under common control to circumvent the consolidation guidance (see Section 4.4.2.3.2).

**Changing Lanes**

In October 2018, the FASB issued ASU 2018-17, which requires all indirect interests held through related parties, regardless of whether they are under common control, to be considered proportionately in the determination of whether a service provider’s fee represents a variable interest (see Section 4.4.2.3.2). For more information on the ASU, see Deloitte’s November 19, 2018, Heads Up.
As a general guideline, the evaluation of whether the collateral manager’s other variable interests absorb more than an insignificant amount of the CIV’s variability is based on whether the variability absorbed by the collateral manager through its other variable interests in the CIV exceeds, either individually or in the aggregate, 10 percent of the CIV’s expected variability. However, because of the subjective nature of the calculation of expected losses and expected residual returns, 10 percent is not a bright line or safe harbor.

The evaluation of a collateral manager’s economic exposure through its other interests should take into account the CIV’s purpose and design. In addition, all risks and associated variability that are absorbed by any of the CIV’s variable interest holders should be considered. The type of interest held by a collateral manager will affect its economic exposure to the CIV and, accordingly, the collateral manager’s conclusion about whether its decision-making arrangement is a variable interest. For example, a first-loss interest is more likely to expose the collateral manager to a significant amount of expected losses or the potential to receive significant expected residual returns than a senior interest.

We expect that substantially all fees charged by collateral managers for services are commensurate with the level of effort required to provide those services and that their fee arrangements contain only customary terms and conditions. Therefore, as long as a collateral manager does not have other interests in the CIV (including interests through its related parties and certain interests held by its related parties under common control) that would absorb more than an insignificant amount of the CIV’s variability, the collateral manager will not have a variable interest in the CIV and will not consolidate the CIV.

See Section 4.4 for further discussion of whether decision-maker or service-provider fees represent a variable interest.

E.2.3.2 Step 2: Does the Collateral Manager Have the Power to Direct the Activities That Most Significantly Affect the CIV?

When the collateral manager has other interests in the CIV (including interests through its related parties and certain interests held by its related parties under common control) that would absorb more than an insignificant amount of the CIV’s variability, the collateral manager would have a variable interest in the CIV and must determine whether it has power over the CIV’s most significant activities.

The economic performance of a CIV is generally most significantly affected by the underlying assets’ performance. Some of the factors that can affect the underlying assets’ performance may be beyond the direct control of any of the parties to the CIV (like voluntary prepayments) and, therefore, do not enter into the power analysis. The activities that most significantly affect the underlying assets’ performance in a CIV are typically related to the collateral manager’s selection, monitoring, and disposal of collateral assets.

In the analysis of which party has the power to direct those activities, questions that should be answered include the following:

- Does the collateral manager hold the power unilaterally?
- Alternatively, do other parties also have relevant rights and responsibilities? For example:
  - Is there another party or other parties that direct other important activities of the CIV? If so, which activities are the most important?
  - Is there another party that has to consent to every important decision?
  - Is there another party that can direct the collateral manager to take certain actions?
  - Is there another party that can replace the collateral manager without cause?
Is there another party or other parties that direct the same activities as the collateral manager but for a different portion of the CIV's assets?

- Is the collateral manager's right to exercise power currently available or contingent on the occurrence of some other event(s)?

E.2.3.2.1 Circumstances in Which a Collateral Manager Might Not Have Power

The collateral manager might not have power in the following situations:

- The collateral manager can be replaced without cause by a single unrelated party (see Section E.2.3.2.2).
- All important decisions require the consent of one or more unrelated parties (see Section E.2.3.2.3).
- The collateral manager manages less than a majority of the assets in the VIE (see Section E.2.3.2.4).

See Section 7.2 for further discussion of evaluating the power criterion.

E.2.3.2.2 Kick-Out Rights

Although not common for CIVs, substantive kick-out rights (i.e., those that can be exercised at will and not upon a contingent event) held by a single party (including its related parties and de facto agents) that are unrelated to the collateral manager prevent the collateral manager from having power because the collateral manager could be removed. Such rights would generally be considered substantive if there are no significant financial or operational barriers to their exercise.

E.2.3.2.3 Shared Power and Participating Rights

The right of an unrelated party to veto all the important decisions made by the collateral manager would, if substantive, prevent the collateral manager from satisfying the power condition since power would be shared. The requirement to obtain consent is considered a participating right when the consent is required for the activities that most significantly affect the legal entity's economic performance. However, when the consent is related only to activities that are unimportant or only to certain of the significant activities, power would not be considered shared. In addition, a reporting entity would need to closely analyze the legal entity's governance provisions to understand whether the consent requirements are substantive (e.g., the consequences if consent is not given).

However, if power is considered shared (e.g., the collateral manager is required to obtain approval from the residual holder for all significant decisions), the collateral manager will need to determine whether the other party (residual holder) is a related party (or de facto agent). If power is considered shared within a related-party group, and the group as a whole has the characteristics of a controlling financial interest, the collateral manager must perform the related-party tiebreaker test to determine which party in the group must consolidate the CIV. ASC 810-10-25-44 provides the following four criteria, which are the same as those under prior GAAP, for consideration in this assessment:

- “The existence of a principal-agency relationship between parties within the related party group.”
- “The relationship and significance of the activities of the [legal entity] to the various parties within the related party group.”
- A party's exposure to the legal entity's variability.
- The legal entity's design.
A collateralized loan entity is formed to acquire commercial loans, drawing down on a line of credit as it identifies new loans. Once the CLO has accumulated sufficient loans to permit securitization, the entity will issue beneficial interests and use the proceeds from the sale of its securities to pay off the warehouse line and purchase any remaining assets needed. The CLO is sponsored by the investment manager.

During the warehousing stage, the investment manager invests $1 million for 20 percent equity ownership in the entity, and other investors provide $4 million for the remaining equity interests in addition to $95 million provided by the bank in the form of a line of credit. The investment manager cannot (1) make any decisions (e.g., loan purchases or issuances of beneficial interests) without approval from the bank or (2) transfer its equity interest in the CLO (the bank is not similarly constrained). Further, the entity is unable to transition from the warehousing phase to the securitization phase without the agreement of all the equity investors and the bank.

The investment manager has determined that the arrangement should be evaluated as a multiphase entity because of the significant uncertainty about the CLO’s ability to transition from the warehousing phase to the securitization phase. In addition, the investment manager has determined that the CLO is a VIE during the warehousing phase since the bank (a nonequity holder) has the ability to participate in the entity’s most significant decisions during this phase. This determination will need to be reevaluated when the CLO proceeds to the securitization phase and issues beneficial interests in the securitization entity (redesign of the CLO).

Under the VIE model, the restrictions imposed on the investment manager’s ability to transfer or encumber its equity interest create a de facto agency relationship between the investment manager and the bank. Therefore, although the decisions that most significantly affect the entity during the warehousing phase require the consent of both parties, because the investment manager shares power with the bank, the investment manager cannot conclude that there is no primary beneficiary of the CLO. Rather, because the related-party group (including de facto agents) meets both criteria in ASC 810-10-25-38A, the investment manager would apply the related-party tiebreaker test in ASC 810-10-25-44 to determine whether it should consolidate the CLO. Note that a different consolidation conclusion may be reached after the CLO’s transition from the warehousing to securitization phase.

### E.2.3.2.4 Multiple Parties With Power

The concept of multiple parties with power can manifest itself in two ways:

- **Multiple parties performing different activities** — It is possible that in certain CIVs, one service provider is engaged to manage investments and another is engaged to manage funding. In such situations, the reporting entity must use judgment and analyze all the facts and circumstances to determine the activity that most significantly affects the economic performance of the legal entity.

- **Multiple parties performing the same activities** — If the joint consent of multiple unrelated parties is required for decisions regarding directing the relevant activities of a legal entity, power is shared, and no party would consolidate. However, when multiple parties individually perform the same activities over separate pools of similar assets, and consent is not required, the party that has unilateral decision making over a majority of the assets would have power over the CIV.
**E.2.3.3 Step 3: Does the Collateral Manager Have a Potentially Significant Interest?**

If a collateral manager determines that its decision-making arrangement is a variable interest as a result of any direct or indirect interests through its related parties, its interests will usually represent an obligation to absorb losses of the VIE or a right to receive benefits from the VIE that could potentially be significant to the VIE. That is, if a collateral manager’s fee is a variable interest because the collateral manager has other direct interests (or indirect interests through its related party) in the CIV that represent a more than insignificant economic interest in the CIV, it would meet the “economics” criterion (ASC 810-10-25-38A(b)) in the primary-beneficiary analysis.

However, if the collateral manager’s fee is a variable interest solely because (1) the fee arrangement is not customary or at market but the collateral manager does not have any direct interests (including the fee) or indirect interests through its related parties that meet the economics criterion or (2) the collateral manager’s related party under common control holds an interest in the CIV in an effort to circumvent the consolidation guidance, the collateral manager may not meet this requirement. The collateral manager would only include interests held by its related parties under common control in the primary-beneficiary analysis if it has a direct interest in those related parties. Accordingly, if the collateral manager’s fee arrangement is a variable interest solely for one of these two reasons, and the collateral manager does not have an interest in those related parties, the collateral manager individually would not have both of the characteristics of a controlling financial interest. However, the collateral manager would still need to assess whether it should consolidate the CIV under the related-party tiebreaker test (step 4).

**E.2.3.4 Step 4: Is the Collateral Manager Required to Perform the Related-Party Tiebreaker Test to Determine Whether It Has a Controlling Financial Interest?**

**E.2.3.4.1 Related Parties Under Common Control**

A collateral manager and its related parties must individually determine which party should consolidate a CIV. Each member of a related-party group with a variable interest in the CIV may determine that it individually does not possess both characteristics of a controlling financial interest but that the related-party group as a whole possesses both characteristics. A reporting entity would perform the related-party tiebreaker test in this situation only if both characteristics of a controlling financial interest reside within a related-party group that is under common control.

We expect that the related-party tiebreaker guidance will apply in extremely limited circumstances to a collateral manager and its related parties under common control. A determination that the collateral manager meets the power criterion through a fee arrangement is most likely to have been made if the collateral manager has a direct or indirect economic interest in the CIV that absorbs more than an insignificant amount of the CIV’s variability (see Section 4.4.2). In addition, when performing the economics-criterion assessment after the adoption of ASU 2016-17, the collateral manager is required to consider its indirect economic interests in a VIE held through related parties under common control on a proportionate basis (see Section 7.3.5.1). Therefore, the related-party tiebreaker guidance would apply to the collateral manager and its related parties under common control only if either (1) the collateral manager fees were not commensurate or at market but the collateral manager does not have any direct interests (including the fee) or indirect interests through its related parties that meet the economics criterion or (2) it was determined that the collateral manager’s decision-making arrangement was a variable interest because a common parent designed the CIV in an effort to circumvent consolidation in the stand-alone financial statements of the collateral manager or related party under common control (see Section 4.4.2.3.2).
Note that in instances in which the collateral manager does not have a variable interest through the fee arrangement in a VIE but the related parties under common control collectively would, if aggregated, have met the power and economics criteria collectively, the parent of the related parties under common control would consolidate the VIE. That is, although the CIV may not be consolidated by either of the subsidiaries in their stand-alone financial statements, the parent must assess the VIE on the basis of its aggregate direct and indirect interests. See Section 7.4.2.3 for further discussion of diversity in practice as a result of a determination that a decision maker with contractual power does not have a variable interest but a related party under common control meets the economics criterion.

E.2.3.4.2 Related Parties Not Under Common Control

If neither the collateral manager nor a related party under common control is required to consolidate a CIV, but the related-party group (including de facto agents) possesses the characteristics of a controlling financial interest, and substantially all of the CIV's activities are conducted on behalf of a single entity in the related-party group, that single entity would be the primary beneficiary of the CIV.

Interests held by the reporting entity's de facto agents (typically as a result of a one-way transfer restriction) would not be included in the consolidation analysis on an indirect basis unless the reporting entity has economic exposure to the VIE through its de facto agents. Accordingly, these restrictions are less likely to result in consolidation.

E.2.4 Reconsideration of Who Controls

The VIE guidance in ASC 810 requires a reporting entity to continually reconsider its conclusion regarding which interest holder is the CIV's primary beneficiary. The collateral manager's conclusion could change as a result of any of the following:

- A change in the legal entity's design (e.g., a change in its governance structure, management, activities, purpose, or in the primary risks it was designed to create and pass through to variable interest holders).
- The addition of terms to the variable interests, or the modification or retirement of terms.
- A change in the holders of a legal entity's variable interests (e.g., a reporting entity acquires or disposes of variable interests in a VIE), causing the reporting entity to have (or no longer have), in conjunction with its other involvement with the legal entity, a variable interest in the CIV.
- A significant change in the anticipated economic performance of a legal entity (e.g., as a result of losses significantly in excess of those originally expected) or other events (including the legal entity's commencement of new activities) that cause a change in the reporting entity's responsibilities such that it now has the power to direct the activities that most significantly affect the legal entity's economic performance.
- Two or more variable interest holders become (or are no longer) related parties.
- A contingent event that transfers, from one reporting entity to another reporting entity, the power to direct the activities of the legal entity that most significantly affect the legal entity's economic performance.

Because continual reconsideration is required, the collateral manager will need to determine when, during the reporting period, the change in primary beneficiary occurred. If the collateral manager determines that it is no longer the primary beneficiary of a CIV, it would need to deconsolidate the CIV as of the date the circumstances changed and recognize a gain or loss. See Section 7.1.5 for a discussion of reassessing the primary beneficiary.
E.2.5 Accounting for Interests in Unconsolidated CIVs

If a collateral manager is not required to consolidate a CIV, it must determine the appropriate accounting for any interests it holds in the CIV. Most interests in CIVs will meet the definition of a “debt security” and are therefore accounted for in accordance with ASC 320. If the investment is a debt security, the collateral manager must first decide whether to elect the “fair value option” and subsequently record its interests at fair value, with fair value changes reported in earnings. The collateral manager can make the election on an item-by-item basis (e.g., for the residual but not the senior interests held in a CIV); however, the election must be made when each investment is first recognized, and it is irrevocable once made.

If the collateral manager decides not to elect the fair value option, it must elect to classify debt securities as trading, available for sale (AFS), or held to maturity (HTM). While this initial classification generally cannot be changed if the holder retains the security, transfers from the AFS category to the HTM category are readily permitted. To classify a security as HTM, the holder must have the positive intent and the ability to hold the security until its maturity. However, if the interest can be prepaid or otherwise settled so that the collateral manager would not recover substantially all of its recorded investment, the instrument cannot be classified as HTM. Given the restrictions on HTM classification, collateral managers typically classify their interests in a CIV as either AFS or trading.

E.2.6 Accounting for Consolidated CIVs

When collateral managers initially consolidate a CIV, they are required to measure the CIVs assets and liabilities at fair value. While some collateral managers subsequently account under ASC 320 for the financial assets of a consolidated CFE as trading, AFS, or HTM, many elect the fair value option and subsequently account for both the financial assets and financial liabilities at fair value. CIVs are CFEs; therefore, a reporting entity that measures both the financial assets and financial liabilities of a consolidated CIV at fair value may use a measurement alternative to determine the fair value of its financial assets and financial liabilities.

See Sections 10.1.3 and 10.2.2 for further discussion of the use of a measurement alternative for the initial and subsequent measurement of CFEs.

E.2.7 Risk Retention Rules

On October 22, 2014, the SEC and five other federal agencies adopted a final rule that requires sponsors of securitizations, under certain conditions, to retain a portion of the credit risk associated with the assets collateralizing an asset-backed security.

Under the final rule, sponsors of securitizations are:

- Required to retain no less than 5 percent of the credit risk of assets in an ABS offering (unless they qualify for certain exemptions).
- Prohibited from financing (other than on a full recourse basis), hedging, or transferring the credit risk they are required to retain for most of the life of the retained security.

Under the risk retention requirements, a sponsor is prohibited from hedging or transferring any interest it is required to retain under the rule to any person other than a majority-owned affiliate. Of particular

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2 The other federal agencies are the Office of the Comptroller of the Currency in the Department of the Treasury, the Board of Governors of the Federal Reserve System, the Federal Deposit Insurance Corporation, the Federal Housing Finance Agency, and the Department of Housing and Urban Development.

3 The final rule was issued in response to a mandate of Section 941 of the Dodd-Frank Wall Street Reform and Consumer Protection Act, which added new credit risk retention requirements to Section 15G of the Securities Exchange Act of 1934.
interest to constituents is whether a collateral manager could comply with the risk retention rule by transferring the retained interest to a consolidated affiliate (i.e., the sponsor either owns a majority [51 percent] stake or a controlling financial interest of a VIE) whose third-party investors own the other interests in the consolidated affiliate. If so, the sponsor’s exposure could be effectively decreased (below 5 percent) when a portion of the risk is absorbed by the third-party investors of the consolidated affiliate. Companies should not only consider the accounting implications of establishing these types of structures but also consult with their legal and regulatory advisers to ensure that they will not be viewed as hedging the credit risk they are required to retain.

The final rule permits sponsors of securitizations to select the form of risk retention obligation, which could be:

- An eligible vertical interest (a proportionate 5 percent interest in every tranche of a securitization).
- An eligible horizontal residual interest (an interest in the first loss tranche of a securitization with a market value equal to at least 5 percent of the market value of all the securities issued).
- A combination of both or an “L-shaped” interest (the combined interest is no less than 5 percent of the market value of all securities issued).

The type of interest retained by the sponsor (i.e., vertical, horizontal, or L-shaped) will affect the sponsor's economic exposure to the securitization structure and, accordingly, the sponsor's consolidation conclusion. If a sponsor holds the subordinate horizontal tranche of a securitization structure, it would be more likely to consolidate the structure than if it holds a vertical interest (or a combination of interests).

At the 2015 AICPA Conference on Current SEC and PCAOB Developments, an SEC staff member, Professional Accounting Fellow Chris Rickli, provided the following example:

In 2014, several federal agencies adopted final rules to implement the Dodd-Frank credit risk retention requirements for asset-backed securities. [Footnote omitted] Over the past several months, OCA has received accounting consultations related to the application of Topic 810 [footnote omitted] to a registrant's involvement with a so-called collateralized manager vehicle, or CMV. CMVs are designed to sponsor various types of securitization transactions.

In one particular fact pattern, the CMV itself was required to hold an ownership interest in the underlying securitization to which it acted as a sponsor. The registrant made an initial equity contribution to the CMV, and obtained one of three seats on the CMV's board of directors. The remaining equity capital was funded by third party investors, several of which were individually significant.

The registrant also entered into a services agreement to provide certain support functions to the CMV, including middle and back office operations, investment research, and other administrative activities.

An aspect of the registrant's consolidation analysis related to whether the CMV was a voting interest entity under Topic 810. The analysis focused heavily on the ownership of the CMV and the role of the CMV's board of directors. The equity holders of the CMV, as represented by the board of directors, had power over the most significant activities of the CMV, including the development of the investment strategy, the hiring and firing of service providers, and the appointment of individuals to the CMV's investment committee. Based on these factors, we did not object to the conclusion that the CMV was a voting interest entity under Topic 810.

We understand that many variations of this type of entity exist in the marketplace. Therefore, it is possible that several of the most significant factors to the analysis may vary greatly from CMV to CMV, and therefore may result in different accounting conclusions. As a result, it would not be appropriate to analogize our conclusions to other fact patterns that involve a CMV.

I would also like to note that our conclusions did not extend beyond the registrant's GAAP accounting analysis. A critical part of the registrant's legal analysis would likely include whether the CMV would qualify as a legal sponsor. This is a legal question and was not addressed as part of the accounting consultation. To the extent there is uncertainty related to legal questions, entities should consult with their primary regulator. [Emphasis added]
An investment manager sponsors a CLO and retains a 5 percent vertical interest (i.e., an interest in each class of ABS interests issued as part of the CLO). The investment manager designed the vertical tranche to be compliant with the risk retention rules. For its role as collateral manager, the investment manager receives remuneration that is customary and commensurate with services performed, including a senior management fee that is paid senior to the notes, a subordinate management fee that is paid senior to the CLO’s preferred shares, and an incentive fee.

Further, the investment manager is the reporting entity that has the contractual right to make decisions related to the activities that most significantly affect the CLO’s economic performance. The vertical interest owned by the investment manager does not absorb more than an insignificant amount of the CLO’s variability (since it owns only 5 percent of all tranches).

The fees received by the investment manager are customary and commensurate with remuneration for services performed (i.e., negotiated at arm’s length). In addition, because the investment manager’s vertical interest would never absorb more than 5 percent of the CLO’s economic performance, once the investment manager appropriately excludes the fees from its variable interest assessment, it would never possess the right to receive benefits or the obligation to absorb losses that are more than insignificant to the CLO (under ASC 810-10-55-37(c)). Therefore, the investment manager’s decision-making agreement would not represent a variable interest. Although the investment manager’s 5 percent vertical interest is a variable interest in the CLO, because the decision-making arrangement is not a variable interest, the investment manager would not be required to consolidate the CLO.

In this example, it is assumed that the other investors are not related parties or de facto agents of the investment manager; if they were, the consolidation conclusion could be affected.

Connecting the Dots
In February 2018, the U.S. Court of Appeals for the District of Columbia in Loan Syndications & Trading Ass’n v. SEC (882 F.3d 220, D.C. Cir. 2018) held that the final risk retention rule does not apply to “open-market CLO” managers. Accordingly, the court reversed the district court’s ruling and instructed it to “grant summary judgment to the [Loan Syndications and Trading Association] on whether application of the rule to CLO managers is valid under [Section] 941, to vacate summary judgment on the issue of how to calculate the 5 percent risk retention, and to vacate the rule insofar as it applies to open-market CLO managers.” The period in which to appeal the circuit court’s decision has lapsed. Preparers are encouraged to consult with their legal advisers regarding the application of the credit risk retention rules to their particular facts and circumstances.

While Example E-2 above focuses on a CLO manager, we believe that it continues to be relevant since it can be applied generally to the consolidation analysis for securitization structures irrespective of whether the risk retention requirements apply.
E.3 Real Estate Structures

E.3.1 UPREIT Structures

In a typical umbrella partnership real estate investment trust (UPREIT) structure, all of the REIT’s assets (properties) are indirectly owned through operating limited partnerships. The REIT as the sole general partner of the partnership makes all the decisions for the operating partnership. The REIT will also hold units (limited partnership interests) in the operating partnership, and the former real estate owners that contributed the property to the partnership in exchange for their interests will hold the remaining units. The units held by these external investors are usually convertible into REIT shares at the option of the unit holder after a specified period. However, they usually do not give the unit holders voting, kick-out, or participating rights in the operating partnership. A typical UPREIT is structured as follows:

Under ASC 810-10-15-14(b)(1), a limited partnership would be considered a VIE unless a simple majority of the limited partners or lower threshold (including a single limited partner) of limited partners have substantive kick-out rights (including liquidation rights) or participating rights. Rights held by the general partner, entities under common control with the general partner, and other parties acting on behalf of the general partner would be excluded from the evaluation of whether limited partners have substantive kick-out rights. See Section 5.3.1.2.3 for a discussion of which parties are considered to be acting on behalf of the general partner.

In a typical UPREIT structure, the operating limited partnership would be considered a VIE because the unit holders do not have substantive kick-out or participating rights. Accordingly, a REIT with a variable interest in the operating partnership would be considered the primary beneficiary of the partnership (and would therefore be required to consolidate the partnership) if it has (1) the power to direct the activities of the operating partnership that most significantly affect the partnership’s economic performance and (2) the obligation to absorb losses of, or the right to receive benefits from, the partnership that could potentially be significant to the partnership.

Because the REIT would typically have the power to direct the activities of the operating partnership, and no one has the ability to remove the REIT as the general partner, if the REIT also has an interest

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4 See Sections 5.3.1.2.4, 5.3.1.2.5, and 5.3.1.2.7 for further discussions of how to evaluate substantive kick-out rights, liquidation rights, and participating rights, respectively.
that could potentially be significant (i.e., under the economics criterion), which is typically the case in an UPREIT structure, the REIT would consolidate the operating partnership.

If the operating partnership is considered a VIE, the REIT may have to comply with the presentation requirements and provide the extensive disclosures currently required for any VIE. However, the REIT may be able to apply the disclosure exemption criterion in ASC 810-10-50-5B (which exempts a reporting entity from providing certain of the VIE disclosures) if the REIT’s partnership interest is considered a “majority voting interest.” See Section 11.2.2.1 for more information. Accordingly, the REIT would be exempt from providing the disclosures in ASC 810-10-50-5A only if the criteria in ASC 810-10-50-5B are met. See Section 11.2 for a discussion of the disclosure requirements.

E.3.2 Land Option Agreements

The homebuilding industry frequently uses land option (or lot option) contracts to procure land for the future construction of homes. In a typical arrangement, a third-party seller owns a parcel of land, which could be finished lots or zoned raw or partially developed land. A homebuilder enters into an agreement with the seller to potentially acquire the land, usually at a fixed price. The seller can be an individual landowner (e.g., a farmer) or an investor group or financial institution acting as a land banker.

To legally separate the land under option from its other assets, the seller forms a land option entity (a potential VIE) and contributes to it the land to be optioned. As consideration for the right to acquire the land, the homebuilder pays to the seller a deposit or provides the seller with an irrevocable letter of credit. The deposit typically varies from 5 percent to 20 percent of the option exercise price of the land under option and is generally nonrefundable. In some circumstances, the homebuilder may make an additional investment in the land by incurring preacquisition costs such as legal costs, roads, or amenities.

The land option agreement allows the homebuilder to purchase all the lots at once or to conduct a “rolling” takedown in which it purchases them according to a predetermined timetable. If, as a result of market factors, the homebuilder decides not to exercise its option, it forfeits its deposit and any preacquisition costs incurred.

The homebuilder’s involvement and economic interest in the potential VIE can vary substantially depending on the arrangement.

E.3.2.1 Determining Whether a Land Option Entity Is a VIE

To be considered a VIE, a land option entity must meet any of the criteria in ASC 810-10-15-14. A land option entity that holds only one parcel of land (and no other assets) is typically a VIE because holders of the equity interests of the land option entity do not have the right to receive expected residual returns as a result of the homebuilder’s holding a fixed-price call option on the sole asset of the entity.

Alternatively, the land option entity may hold multiple parcels of land that could be subject to multiple land option agreements with multiple parties. The homebuilder may have a land option agreement on one or more of the parcels. When determining whether a land option entity that holds multiple parcels of land is a VIE, the homebuilder should consider the following:

- How it was financed and whether it has sufficient equity investment at risk (see Section 5.2).
- Which party has the power to direct the activities that most significantly affect its economic performance (see Section 5.3).
- Whether the homebuilder has made a nonrefundable deposit and whether the interest is in specified assets or silos (see Section 4.3.11 and Chapter 6, respectively).
The homebuilder should analyze each consideration as follows:

- **Sufficiency of equity investment at risk** — The homebuilder should consider how the potential VIE was financed (i.e., through equity, nonrecourse debt, debt that is recourse to the land and equity, or a combination of these sources).

- **Power to direct the activities of the potential VIE that most significantly affect its economic performance** — If, as a group, the equity investors lack the power to direct the activities of the land option entity that most significantly affect its economic performance, the land option entity would be deemed a VIE. To perform this analysis, the reporting entity must determine whether the potential VIE’s equity holder (generally the seller) has the power to direct the activities that most significantly affect the land option entity’s economic performance (see Section E.3.2.2).

- **Obligation to absorb losses/right to receive returns of the potential VIE** — When the land option entity holds many parcels of land, the homebuilder may only have an interest in certain of these parcels (i.e., an interest in specified assets). In accordance with ASC 810-10-25-55, if the homebuilder has an interest in specified assets of the potential VIE and (1) the fair value of the specified assets is more than half the total fair value of the potential VIE’s assets or (2) if the homebuilder has another variable interest in the potential VIE as a whole, the land option is a variable interest in the potential VIE. Otherwise, the homebuilder — through the land option — may have an interest in specified assets. If so, when determining whether the land option entity is a VIE, the homebuilder does not need to analyze the land option entity further unless it holds an interest in a silo.

### E.3.2.2 Which Party Should Consolidate a Land Option Entity (or Silo) That Is a VIE

ASC 810-10-25-38A states that a reporting entity has a controlling financial interest in a VIE if it has both (1) the power to direct the activities that most significantly affect the VIE’s economic performance and (2) an obligation to absorb losses or receive benefits of the VIE that could potentially be significant to the VIE. In this assessment, the homebuilder should consider the design and purpose of the VIE as well as the risks the VIE was designed to create and pass along to the variable interest holders (see Section 7.2 for general information about determining which party has power over a VIE). If the homebuilder concludes that its purchase option represents a variable interest, the interest will generally represent a right to receive benefits that could potentially be significant to the VIE; the probability that the homebuilder will receive significant benefits is generally not a consideration in this analysis (see Section 7.3.2).

To determine whether the homebuilder has the power to direct the activities that most significantly affect the economic performance of the VIE, the homebuilder should consider the risks the VIE was designed to create and pass through to the variable interest holders. For a land option entity, such risks may include (1) fluctuation in the value of the underlying land, (2) the homebuilder’s credit, (3) noncompletion of land development activities, (4) failure to obtain zoning and environmental approvals, and (5) operations risk related to any other activities of the land option entity. Once the homebuilder identifies relevant risks, it should evaluate which of the risks are expected to have the most significant impact on the economic performance of the entity.

After the homebuilder has identified the risks that are expected to have the most significant impact on the economic performance of the land option entity, the homebuilder should consider which decisions are the most important regarding the activities that are used to manage those risks. The decisions and related activities that may affect the economic performance of a land option entity are discussed below.

Assumptions about which activities will most significantly affect the economic performance of the VIE may change as the primary-beneficiary determination is continually reassessed. The homebuilder should consider any new assumptions associated with such primary-beneficiary reconsiderations.
The following activities may affect economic performance:

- **Land development work** — The assessment of which party directs the most significant land development activities may include which party sets and approves the budget, makes decisions related to scope and timing for the work to be performed, and absorbs cost overruns. It may also include whether the other parties hold any approval rights that are substantive.

- **Zoning and environmental responsibilities** — The homebuilder should consider which party directs the activities related to obtaining zoning rights and environmental approvals for the land. If the homebuilder assumes the risk of and responsibility for performing these activities, the homebuilder should consider whether it is required to exercise the option or pay any penalties if these activities are not completed.

- **Debt/financing transactions** — The homebuilder should consider what debt-related transactions the VIE can conduct, if any (i.e., pay off existing debt, incur additional unsecured debt, incur additional secured debt for the nonoptioned land in the VIE); whether it expects that any of these transactions will occur; and which party directs these activities.

- **Acquisition of additional land** — The homebuilder should consider whether the VIE’s organizational documents allow it to purchase additional properties, whether the design of the VIE allows it to purchase additional properties, and whether (1) such decisions are fully within the control of the seller or (2) the homebuilder has approval rights over these decisions.

- **Disposition of remaining land** — If additional land is available in the VIE (either when the homebuilder enters into the option contract or subsequently because more land is acquired), the homebuilder should consider whether the land use, development, and ultimate disposition is at the discretion of the seller or whether the homebuilder may influence these decisions.

- **Other rights under the agreement** — The homebuilder may have the ability to defer or cancel scheduled takedowns under the option contract, push back or cancel a development phase, change the deposit or development fee provisions, or exercise other provisions under the existing contract terms. The homebuilder should consider the ability to exercise such rights in the analysis of which party has the power to direct the most significant activities.

Alternatively, the parties under the arrangement could amend the contract terms. The homebuilder should consider whether an amendment of the contract terms represents a reconsideration event (see Chapter 9). In addition, in performing its continual assessment of the primary beneficiary, the homebuilder should determine whether the amendment changes the primary-beneficiary conclusion.

- **Expiration of the land option** — The homebuilder should consider provisions that specify (1) certain activities to occur after a land option expires and (2) which party directs these activities (e.g., development activities).

- **Other operating activities of the entity** — If the entity is using the land for revenue generating activities, the homebuilder may need to consider decisions related to those activities.

Although the primary-beneficiary analysis focuses on a party’s power to direct the activities of the VIE that most significantly affect its economic performance, the homebuilder should carefully consider situations in which it has significant investment and involvement in a land option entity. ASC 810-10 requires the reporting entity to analyze the substance of the overall arrangement as well as exercise additional skepticism when the relative economic interests of the parties to the arrangement are inconsistent with their stated power. In performing the primary-beneficiary analysis, the homebuilder
may find it useful to consider the significance of its investment in the VIE (including nonrefundable deposits and any preacquisition costs) relative to the option exercise price of the land under option as well as the nature of the seller (i.e., financial institution, land banker, or individual property owner). In addition, in determining whether it is the primary beneficiary, the homebuilder should consider its indirect interests in the VIE held by its related parties.

To identify the primary beneficiary, the homebuilder must determine the ongoing activities of a VIE that are expected to significantly affect its economic performance. Although ASC 810-10-25-38F states that a reporting entity’s involvement in the design of a VIE “may indicate that the reporting entity had the opportunity and the incentive to establish arrangements that result in the reporting entity being the variable interest holder with . . . the power to direct the activities that most significantly impact [the VIE’s] economic performance,” determining the primary beneficiary solely on the basis of decisions made at the VIE’s inception — as part of the VIE’s design — would not be appropriate when there are ongoing activities that will significantly affect the VIE’s economic performance.

E.4 LIHTC Structures

E.4.1 Background

In an LIHTC partnership structure, the general partner typically has an insignificant equity interest in the partnership but receives a fee for its decision-making responsibilities, including building and renovating the housing project, issuing partnership interests, and maintaining and operating the housing project. The limited partners invest in these projects to earn the tax benefits, and they hold essentially all of the equity interest.

E.4.2 Determining Whether a LIHTC Partnership Structure Is a VIE

A reporting entity is required to apply either the VIE model or the voting interest entity model in performing its consolidation assessment. A limited partnership would be considered a VIE regardless of whether it otherwise qualifies as a voting interest entity unless either of the following apply:

- A simple majority or lower threshold (including a single limited partner) of the limited partners (excluding interests held by the general partner, entities under common control with the general partner, and other parties acting on behalf of the general partner) with equity at risk have substantive kick-out rights (including liquidation rights — see Section 5.3.1.2.2).
- The limited partners with equity at risk have substantive participating rights (see Section 5.3.1.2.7).
Although a reporting entity should exercise judgment and consider all facts and circumstances, the partnership agreement in an LIHTC structure typically does not allow the limited partners to participate in the policy-making processes of the partnership or remove the general partner without cause. Factors to consider in the determination of whether the limited partner investors participate in the policy-making processes of a LIHTC partnership include the following:

- Whether the investor has the ability to make decisions about the day-to-day operations of the LIHTC partnership (e.g., accepting tenants, setting rent).
- Whether the investor has the unilateral ability to veto the operating and capital budgets or otherwise prevent the general partner from making decisions about the day-to-day operations of the LIHTC partnership without cause.

Accordingly, while protective rights may exist (e.g., the ability to remove the general partner with cause or to veto the sale of a property owned by the LIHTC partnership for significantly less than its fair value), a LIHTC partnership is typically considered a VIE as a result of the lack of substantive kick-out or participating rights.

Although a LIHTC partnership will typically be considered a VIE because of its lack of participating or kick-out rights, the partnership may also fail to satisfy the other VIE criteria. However, if such rights exist, and the partnership meets all of the conditions to qualify as a voting interest entity, a single limited partner with the ability to remove the general partner would be required to consolidate the partnership under the voting interest entity guidance.

**E.4.3 Which Party Should Consolidate a LIHTC Structure That Is a VIE?**

The assessment of whether a reporting entity is required to consolidate a limited partnership that is a VIE focuses on whether the reporting entity has both of the following characteristics of a controlling financial interest:

- **Power** — The power to direct the activities that most significantly affect the VIE’s economic performance (see Section 7.2).
- **Economics** — The obligation to absorb losses or the right to receive benefits of the VIE that could potentially be significant to the VIE (see Section 7.3).

Often, despite not having made a significant equity investment, the general partner will meet both of these conditions and would consolidate the LIHTC partnership. For example, in situations in which the general partner is providing guarantees for construction or operations, the general partner may have, on its own, the characteristics of a controlling financial interest and would therefore be the primary beneficiary.

However, when the general partner does not meet both conditions (e.g., when a guarantee is not provided), typically no party individually would have both of the characteristics of a controlling financial interest. Specifically, the general partner may conclude that it meets the power criterion but not the economics criterion, and each limited partner may conclude that it does not meet the power criterion. However, facts and circumstances (including whether any partners have other interests in the partnership or each other) must be considered. For example, if the partnership is a VIE, and a single limited partner has the right to remove the general partner, the limited partner may have, on its own, the characteristics of a controlling financial interest and would be required to consolidate the partnership.
E.4.4 How Do Interests Held by Related Parties Affect the Analysis?

In certain instances, the limited partner or partners may be related parties or de facto agents or de facto principals of the general partner. For example, if the general partner is restricted from disposing of its interest without the approval of the limited partner and no similar restriction exists that limits the ability of the limited partner to dispose of its own interest, the general partner would be considered a de facto agent of the limited partner. A reporting entity would perform the related-party tiebreaker test in the following instances:

- Power is shared within a related-party group and the related-party group meets both characteristics of a controlling financial interest. See Section 7.2.7.1 for further discussion of determining whether power is shared.
- A single decision maker has met the power criterion but not the economics criterion, and the aggregation of entities under common control with the single decision maker have met the economics criterion. See Section 8.3 for further discussion of common control.

In addition, in accordance with ASC 810-10-25-44B, a reporting entity in a single decision maker’s related-party group\(^5\) should generally consolidate a VIE if (1) the reporting entity is a party that is related to a single decision maker that does not, individually, have both characteristics of a controlling financial interest, (2) no other party in the single decision maker’s related-party group individually has both characteristics of a controlling financial interest in the VIE, (3) the single decision maker and its related parties under common control do not have both characteristics of a controlling financial interest, and (4) substantially all of the activities of the VIE either involve or are conducted on behalf of the reporting entity. However, as stated in ASC 810-10-25-44B, this requirement does not apply if the legal entity is a partnership in a LIHTC structure that meets criteria in ASC 323-740-15-3 and ASC 323-740-25-1. Accordingly, this exception for LIHTC structures applies only if the legal entity is a limited liability entity established for affordable housing projects that is a flow-through entity for tax purposes (i.e., the criteria per ASC 323-740-15-3) and the following conditions in ASC 323-740-25-1 are met:

- a. It is probable that the tax credits allocable to the investor will be available.
- aa. The investor does not have the ability to exercise significant influence over the operating and financial policies of the limited liability entity.
- aaa. Substantially all of the projected benefits are from tax credits and other tax benefits (for example, tax benefits generated from the operating losses of the investment).
- b. The investor’s projected yield based solely on the cash flows from the tax credits and other tax benefits is positive.
- c. The investor is a limited liability investor in the limited liability entity for both legal and tax purposes, and the investor’s liability is limited to its capital investment.

This exception, which applies only in these circumstances, is intended to prevent situations in which a single limited partner investor that holds more than 90 percent of the limited partner interests in a LIHTC partnership may have otherwise had to consolidate the partnership if the general partner is a related party or de facto agent of the investor.

E.5 Power and Utilities Entities

E.5.1 Overview

Reporting entities in the power and utilities (P&U) industry apply the same consolidation requirements as reporting entities in other industries. However, the consolidation analysis may be particularly challenging in the P&U context. This section supplements the main chapters of this publication by

\(^5\) See footnote 3.
discussing topics that apply to P&U reporting entities in their evaluation of whether they are required to consolidate a legal entity.

E.5.2 Identification of Variable Interests

Only a holder of a variable interest can consolidate a VIE. Accordingly, as long as the legal entity being evaluated does not qualify for a scope exception, the reporting entity must determine whether its interest in a legal entity is a variable interest. Examples of potential variable interests include equity interests, debt interests, PPAs, derivative instruments, management agreements, and other operating or contractual arrangements. The determination of whether an interest is a variable interest is often complicated and should focus on the purpose and design of the legal entity being evaluated and the risks to which the legal entity was designed to be exposed. For more information about identifying variable interests, see Chapter 4.

E.5.2.1 PPAs and Tolling Arrangements

Performing the variable-interest assessment for PPAs and tolling arrangements can be particularly challenging. A reporting entity must first determine whether the arrangement is considered an operating lease under ASC 840 or ASC 842 or a derivative under ASC 815 and, accordingly, whether the arrangement (1) qualifies for the scope exception in ASC 810-10-55-39 for an operating lease (see Section E.5.2.1.2) or (2) is a derivative that creates (rather than absorbs) variability (see Section E.5.2.3).

If the arrangement does not meet the definition of an operating lease (or there are other elements embedded in the operating lease) or the arrangement is not a derivative that creates (rather than absorbs) variability, the determination of whether a PPA or tolling agreement is a variable interest should focus on the purpose and design of the legal entity being evaluated and the risks to which the legal entity was designed to be exposed, such as raw-material price risk, operations risk, credit risk, and electricity price risk. The evaluation should take into account the nature of the pricing in the PPA or tolling arrangement (fixed, market, cost-reimbursement, etc.) as well as any features related to the underlying plant (puts, calls, residual value guarantees).

Further, the nature of the generating facility could affect the evaluation. That is, a fixed-price forward contract to purchase electricity from a fossil-fuel facility that has not yet been generated will typically be viewed as a contract to purchase an asset (electricity) that the legal entity does not currently own because of the legal entity’s exposure to raw material price risk and O&M risk in producing the electricity. In accordance with ASC 810-10-55-27, a contract to buy an asset that is not currently owned by a legal entity at a fixed price will usually increase the legal entity’s variability (rather than absorb it). In contrast, a fixed-priced forward contract to buy electricity from a renewable energy facility that has limited exposure to raw material price risk or O&M risk would typically be evaluated in a manner similar to an interest in a legal entity that currently owns the asset, because the entity has limited exposure to raw material price risk or O&M risk. Under ASC 810-10-55-28, a fixed-price contract for the legal entity to sell and for the counterparty to buy an asset owned by a legal entity is more likely to absorb variability of the legal entity.

The reporting entity should also consider any other contracts it holds, as well as those held by its related-party group, when evaluating whether a PPA or tolling arrangement is a variable interest.

Views have differed historically on the approach a reporting entity should use to assess variability, which has somewhat hindered comparability between reporting entities. Specifically, reporting entities will apply either a cash flow approach (the legal entity’s variability arises from fluctuations in its cash flows) or

6 In many situations, the evaluation of whether a PPA is (or contains) a lease may be relatively simple; however, there is diversity in practice related to how this evaluation should be performed. See Section E.5.2.1.1 for additional information.
a fair value approach (the source of a legal entity's variability arises from fluctuations in the fair value of the legal entity's net assets).

Example E-3 below illustrates how particular PPAs, tolling agreements, or similar arrangements should be evaluated in a reporting entity's determination of whether such contracts are variable interests.

**Example E-3**

- A legal entity (PowerCo) is created to hold a generating facility and is funded by two unrelated equity holders and one unrelated debt holder.
- PowerCo uses the proceeds from the equity contributions and debt to purchase the generating facility.
- As a condition of lending, the debt holder requires PowerCo to enter into a 20-year forward contract to sell 100 percent of its output to a third party.
- PowerCo holds the title to the facility, which has a useful life of 40 years.

Table E-1 below outlines how to assess whether a PPA, tolling agreement, or similar arrangement between the Utility and PowerCo in Example E-3 is a variable interest. These contracts are analyzed from the purchaser's perspective (first column). The second column describes other arrangements entered into between the legal entity (PowerCo) and either a third party or the purchaser. Assume that the guidance on derivatives in ASC 810-10-25-35 and 25-36 does not apply and that the contract is not an operating lease. Ultimately, whether a contract is a variable interest will depend on individual facts and circumstances, including the risk profile of the production facility (i.e., renewable energy versus fossil-fuel plants).

**Table E-1 — Assessing Whether PPAs, Tolling Agreements, or Similar Arrangements Are Variable Interests**

<table>
<thead>
<tr>
<th>Type of Contract (Purchaser)</th>
<th>Existing Contracts for Fuel and Other Materials</th>
<th>Is the Purchaser's Contract a Variable Interest?</th>
</tr>
</thead>
<tbody>
<tr>
<td>Fixed-price forward contract to purchase electricity</td>
<td>Market-price forward contract to purchase fuel from a third-party provider</td>
<td>No. The legal entity is designed to be subject to operating risk, credit risk of the purchaser, and fuel price risk. The role of the fixed-price forward contract is not to transfer any portion of those risks from the equity and debt investors to the purchaser since the price paid under the forward contract does not change as a result of changes in operating costs, fuel prices, or default by the purchaser. Those risks are designed to be borne by the equity and debt investors.</td>
</tr>
</tbody>
</table>
### Table E-1 — Assessing Whether PPAs, Tolling Agreements, or Similar Arrangements Are Variable Interests

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</tr>
</thead>
<tbody>
<tr>
<td>Fixed-price forward contract to purchase electricity</td>
<td>Fixed-price forward contract to purchase fuel from a third-party provider</td>
<td>No. The legal entity is designed to be subject to operating risk, credit risk of the purchaser, and fuel price risk. The role of the fixed-price forward contract to purchase electricity is not to transfer any portion of those risks to the purchaser since the price paid under the forward contract does not change as a result of changes in operating costs, fuel prices, or default by the purchaser. Those risks are designed to be borne by the equity and debt investors and the counterparty to the fixed-price raw material supply contract.</td>
</tr>
<tr>
<td>Fixed-price forward contract to purchase electricity</td>
<td>Fixed-price forward contract to purchase fuel from the purchaser</td>
<td>Yes. The legal entity is designed to be subject to operating risk, credit risk of the purchaser, and the fuel price risk. The role of the fixed-price forward contracts held by the purchaser, when these contracts are evaluated together, transfers the fuel price risk from the equity and debt investors to the purchaser. This arrangement is equivalent to the purchaser entering into a variable-price forward contract that is designed to reimburse the legal entity for changes in fuel prices.</td>
</tr>
<tr>
<td>Fixed-price forward contract to purchase electricity</td>
<td>Renewable energy PPA — no fuel costs</td>
<td>Some reporting entities have concluded that fixed-price PPAs for renewable energy contracts do not represent variable interests under the cash flow approach. That is, the fixed-price PPA does not absorb the variability in production costs such as O&amp;M costs or the credit risk of the purchaser. Rather, such variability is absorbed by the equity and debt investors. However, others have concluded that these contracts do represent a variable interest under the fair value approach. This conclusion is based on the fact that renewable energy resources have significantly lower variable production costs than traditional fossil-fuel generating units (i.e., they have a lower variable O&amp;M cost profile and no fuel costs). Accordingly, by analogy to the guidance in ASC 810-10-55-28, the fixed-price-per-unit contract would absorb variability related to the underlying assets of the entity (e.g., the windmill or solar panels) if there are changes in commodity prices.*</td>
</tr>
<tr>
<td>Tolling arrangement in which the purchaser provides fuel to the legal entity at no cost or transfer of title and purchases 100 percent of the output at a specified charge per unit (conversion cost)</td>
<td>Agreement to provide fuel included in the tolling arrangement</td>
<td>Yes. The legal entity is designed to be subject to operating risk, credit risk of the purchaser, and fuel price risk.** The role of the tolling arrangement transfers the fuel price risk from the equity and debt investors to the purchaser. Changes in the fuel prices will be borne by the purchaser. This arrangement is equivalent to the purchaser’s entering into a variable-price forward contract that is designed to reimburse the legal entity for changes in fuel prices.</td>
</tr>
</tbody>
</table>
Type of Contract (Purchaser) | Existing Contracts for Fuel and Other Materials | Is the Purchaser’s Contract a Variable Interest?
--- | --- | ---
Variable-price forward contract to purchase electricity — reimburses legal entity for costs of fuel and O&M | Market-price forward contract to purchase fuel from a third-party provider | Yes. The legal entity is designed to be subject to operating risk, credit risk of the purchaser, and fuel price risk. The role of the variable-price forward contract is to transfer the fuel price risk and some portion of operating risk from the equity and debt investors to the purchaser. Changes in the fuel prices and O&M costs will be borne by the purchaser.

Variable-price forward contract to purchase electricity — reimburses legal entity for costs of fuel and O&M | Market-price forward contract to purchase fuel from the purchaser | Yes. The legal entity is designed to be subject to operating risk, credit risk of the purchaser, and fuel price risk. The role of the variable-price forward contract is to transfer the fuel price risk and some portion of operating risk from the equity and debt investors to the purchaser. Changes in the fuel prices and O&M costs will be borne by the purchaser.

Variable-price forward contract to purchase electricity — reimburses the legal entity for costs of fuel and O&M. A component of the variable-price forward contract is considered an operating lease | Market-price forward contract to purchase fuel from a third-party provider | Yes. The legal entity is designed to be subject to operating risk, credit risk of the purchaser, and fuel price risk. Although a component of the variable-price forward contract is considered an operating lease, the role of the remaining, nonlease components of the arrangement is to transfer fuel price risk and some portion of operating risk from the equity and debt investors to the purchaser. Changes in the fuel prices and O&M costs will be borne by the purchaser.

* PPAs for renewable energy that are ostensibly fixed-price-per-unit contracts often have features designed to absorb cash flow variability. For example, construction overrun contingencies or tax contingencies that can change the fixed price per unit of the facility’s output would absorb variability in the cash flows of the legal entity. It is important for a reporting entity to ensure that the PPA truly is a fixed-price-per-unit contract before concluding that the arrangement does not absorb cash flow variability.

In addition, regardless of whether the PPA for renewable energy represents a variable interest, given the noncontrollable risks (i.e., risks for which there are no related activities) in a typical renewable structure, the off-taker often will conclude that it does not have power over the most significant activities since the power over the controllable risks (such as O&M) frequently rests with the owner-operator. This conclusion will depend on the particular terms of each arrangement. See Section E.5.4.

** Although the legal entity does not take title to the fuel in a tolling arrangement, the legal entity must produce electricity, which requires fuel. By supplying the legal entity with fuel at no cost, the reporting entity is implicitly absorbing fuel price risk associated with producing the electricity. This concept is consistent with the SEC’s speech on “activities around the entity” — see Section 4.3.10.1.

E.5.2.1.1 Determining Whether a PPA Is a Lease Agreement

It is not uncommon for PPAs and tolling arrangements to qualify as leases for accounting purposes. The evaluation of whether a contract is (or contains) a lease under ASC 840 focuses on whether (1) specified assets must be provided for the contract to be fulfilled and (2) the contract conveys the right to control the use of a specified asset for an agreed period. Further, the right to control the use of a specified asset is conveyed if the customer will obtain all but an insignificant amount of the output or other utility of the asset during the term of the arrangement, and the price that the entity will pay for the output is neither contractually fixed per unit of output nor equal to the current market price per unit of output as of the time of output delivery.
Currently there is diversity in practice related to how to evaluate whether a PPA is a lease under ASC 840 as a result of differing views about how to interpret the terms “output” and “contractually fixed per unit of output.” For example, questions have been raised regarding whether an “output” should include both physical and intangible outputs (e.g., renewable energy credits (RECs), which represent rights for environmental benefits) and whether “contractually fixed per unit of output” encompasses certain escalation clauses (e.g., specified escalation percentages or escalation based on an inflation index) or separate fixed pricing for different times of the day.

ASC 842 amends the definition of a lease and the evaluation of control. It also indicates that a lease is a contract — or part of a contract — in which a supplier conveys to a customer “the right to control the use of identified property, plant, or equipment . . . for a period of time in exchange for consideration.” An entity must determine whether there is an identified asset and, if so, whether the customer has the right to both obtain substantially all of the economic benefits of its use and direct its use. A PPA may contain a lease (i.e., there may be an embedded lease) under ASC 842. See Sections 3.2 and 3.4 of Deloitte's A Roadmap to Applying the New Leasing Standard for further discussion.

E.5.2.1.2 Operating Lease Scope Exception

ASC 810-10-55-39 indicates that most arrangements that qualify as operating leases (i.e., the lease does not transfer substantially all of the risks and rewards of ownership) do not absorb variability in the fair value of the VIE’s net assets. Accordingly, a lessee under a PPA or tolling arrangement that is considered an operating lease may not be considered to hold a variable interest in a VIE lessor entity.

However, it is important to remember that the exception for operating leases only applies to the lease element of an arrangement. Therefore, PPAs that qualify as operating leases may still contain variable interests to the extent that other elements (e.g., fixed-price put or call options, dismantlement/decommissioning obligations) exist in the lease. Other common features embedded in an operating lease include management or service arrangements, the obligation to absorb the variable costs of production, and raw material supply arrangements (e.g., a fuel-tolling arrangement). Reporting entities must understand the terms of the lease arrangement and identify all embedded features.

E.5.2.1.3 Capital Leases

Capital leases (including PPAs and tolling arrangements) are not eligible for the operating lease scope exception, and often the features that trigger capital lease accounting (e.g., bargain purchase options, residual value guarantees) will absorb variability. Further, just because an arrangement is a capital lease does not minimize the relevance of, or negate the need for, the consolidation analysis. Accordingly, a lessee reporting entity that enters into a capital lease would still need to assess whether its lease is a variable interest and ultimately whether it is required to consolidate the lessor. If the reporting entity is required to consolidate the lessor, any other assets or obligations of the lessor would be included in the reporting entity's consolidated financial statements. See Section 4.3.9.2 for additional discussion.

Note that in February 2016, the FASB issued ASU 2016-02 (codified in ASC 842), which removes the term “capital lease” from GAAP and replaces it with “finance lease.” Nevertheless, upon adopting ASC 842, a reporting entity would apply this guidance to its finance leases in the same manner it applied it to its capital leases before adopting ASC 842.
E.5.2.1.4 Avoided Cost Pricing

It is not uncommon for a utility to purchase power from qualifying facilities under avoided-cost pricing structures in accordance with the Public Utility Regulatory Policies Act and the Energy Policy Act. Since avoided cost is generally a measure of the utility's marginal cost to produce the same amount of energy through construction of a new plant and does not permit direct reimbursement for any of the generator's actual costs of production, avoided-cost pricing will generally not absorb risk of the generator; however, there may be exceptions. Relevant considerations include the fuel source and operating profile of the utility's marginal unit compared with the fuel source and operating profile of the generator and the reset period for the price schedule. In circumstances in which (1) the fuel source and operating profile of the utility's marginal unit closely mirror that of the generator and (2) the reset period on the pricing is frequent (e.g., monthly), it may be appropriate to conclude that the PPA is absorbing variability in the legal entity. The use of a correlation analysis may be helpful to the reporting entity in making this determination.

E.5.2.1.5 Curtailment Rights

There have been questions about the effects of voluntary or economic curtailment clauses on the assessment of whether a PPA is a variable interest. Specifically, entities have asked whether the off-taker would absorb variability in the legal entity if the penalty pricing for economic curtailment was the same as the pricing that would have been due had the unit generated power. This type of penalty pricing would not, in and of itself, make a PPA a variable interest, because the off-taker is not absorbing incremental cash flow variability in curtailment scenarios.

E.5.2.2 Renewable Energy Credits

If a reporting entity concludes that RECs are an output of a specified asset and that the overall arrangement (including the benefits from the RECs) should be accounted for as a lease, the lessee would not be required to separately evaluate whether the right to receive the RECs is a separate variable interest (see Section E.5.2.1.1). See Section 3.4.1.1 of Deloitte's A Roadmap to Applying the New Leasing Standard for further discussion.

However, if the reporting entity concludes that the RECs are not an output of the specified asset in its evaluation of whether the arrangement is a lease, or if the sale of the RECs is not part of a lease arrangement, the reporting entity should assess the obligation to purchase the RECs separately to determine whether the right is a variable interest.

E.5.2.3 Derivative Instruments

During the development of the by-design approach, the FASB debated whether certain derivative instruments, such as interest rate swaps and foreign currency swaps, should be considered variable interests in a legal entity by the counterparty to the derivative. From an economic standpoint, these types of derivatives could be viewed as both creating and absorbing variability in a legal entity. For example, in an interest rate swap in which the legal entity pays a fixed rate and receives a variable rate, the counterparty is absorbing fair value variability and creating cash flow variability for the legal entity. Although it would be atypical for such an instrument to give the counterparty power over the legal entity, the principles in ASC 810-10-25-35 and 25-36 provide a framework for the counterparties to conclude that many of these instruments are not variable interests in the legal entity, which permits the counterparties to avoid further analysis of whether the legal entity is a VIE as well as the disclosures required by variable interest holders in a VIE.
Under ASC 810-10-25-35 and 25-36, even if a derivative instrument absorbs variability, it may be considered a creator of variability (i.e., not a variable interest) as long as it does not absorb all or essentially all of the variability from a majority of the legal entity's assets and it possesses the following two characteristics:

- "Its underlying is an observable market rate, price, index of prices or rates, or other market observable variable (including the occurrence or nonoccurrence of a specified market observable event)." (See Section 4.3.3.2 for a discussion of the meaning of the term “observable market.”)
- "The derivative counterparty is senior in priority relative to other interest holders in the legal entity."

Questions have been raised regarding the application of the derivative-specific guidance in ASC 810-10 to nonderivatives, generally in the context of unrecognized executory contracts (e.g., PPAs) that appear to both absorb risk (e.g., commodity price risk) and create new risk (e.g., credit of the off-taker). The guidance in ASC 810-10-25-35 and 25-36 is confined to derivatives (as determined under ASC 815). Accordingly, a reporting entity would be prevented from applying this guidance if, for example, there is no explicit or implicit notional amount in the PPA, or if the output under the PPA (power) does not meet the net settlement criteria in ASC 815-10-15-110 and ASC 815-10-15-119. See Section 4.3.3.1 for further discussion of the meaning of a derivative instrument in this context.

Example E-4

A reporting entity forms a legal entity to construct and hold a single plant that will produce electricity. The plant has an estimated useful life of 40 years and is financed with equity (10 percent) and nonrecourse debt (90 percent). During the formation of the legal entity, the reporting entity enters into a forward contract to buy 100 megawatts of the electricity produced by the plant, which is approximately 60 percent of the plant's yearly electricity production, for 25 years. The forward contract is at a variable price, reimbursing the legal entity for raw materials and O&M costs. The reporting entity has no other involvement with the legal entity. The legal entity can choose to purchase the raw materials needed to produce the electricity on the spot market either when it needs them or before. Assume that the forward contract possesses the following characteristics necessary for the application of ASC 810-10-25-35 and 25-36:

- The forward contract meets the definition of a derivative in ASC 815.
- The forward contract's underlying (electricity) has an observable market price.
- The reporting entity is senior in priority to the legal entity's other interest holders. (In this instance, the reporting entity's interest is senior in priority to the nonrecourse debt; often, this is not the case.)

Further, the reporting entity has identified that the legal entity is designed to be exposed to risks related to construction, raw-material prices, O&M, and credit of the purchaser. The forward contract would probably be considered a creator of variability even though the contract absorbs the variability associated with the raw-material price risks and the O&M risk. Although the forward contract is related to a majority of the operations of the legal entity, changes in the cash flows or fair value of the forward contract are not expected to offset all, or essentially all, of the risk or return (or both) related to the output of the legal entity. Specifically, the forward contract is designed to absorb approximately 60 percent of the plant's raw-material price risk and O&M risk, which do not constitute essentially all the risk in the legal entity.

E.5.2.4 Rate-Regulated Entities — Ratepayers Are Not Variable Interest Holders

Regulated utility companies many times enter into a PPA to purchase all the power of a power-generating plant at an amount equal to a fixed capacity payment plus the variable costs of fuel, operations, and maintenance. The regulated utility company generally expects that all of its costs incurred under the PPA will be recovered from ratepayers under the rate regulation statutes in its operating jurisdiction. Further, in many instances, the power-generating plant is the sole asset of a VIE.
Although the regulated utility is permitted to pass the costs of the PPA to its ratepayers as they are billed for services in the future, no identifiable ratepayers have the obligation to absorb the VIE's economics at the present time. That is, an individual ratepayer does not have an obligation to absorb the variability in the PPA until the ratepayer consumes electricity in the future. Further, the ratepayer is not obligated to absorb any of the VIE's variability if electricity is not purchased in the future (e.g., if the ratepayer uses alternative energy sources or moves to another state).

Because the individual ratepayers do not have an obligation, contractual or otherwise, to absorb the variability of the regulated utility's arrangement with the VIE, the indirect involvement of the ratepayers does not meet the definition of a variable interest. As a result, the variability passed through the PPA between the regulated utility and the VIE is considered to be absorbed completely by the regulated utility under the VIE model, and no portion of that variability should be attributed to the ratepayers.

### E.5.3 Determining Whether the Legal Entity Is a VIE

To the extent that a PPA, tolling agreement, or similar off-take arrangement is deemed to be a variable interest, or when a reporting entity has other variable interests in the legal entity (e.g., equity interests, loans, guarantees), the reporting entity is required to consider whether the legal entity is a VIE and, accordingly, whether to apply the VIE model or the voting interest entity model in performing its consolidation assessment. To determine which model to use, the reporting entity must determine whether any of the following conditions apply:

- The legal entity has insufficient equity at risk to finance its activities.
- The equity holders (as a group) lack any of the three characteristics of a controlling financial interest.
- Members of the equity group have nonsubstantive voting rights.

If any of these conditions apply, the equity is not considered substantive, and the legal entity should be evaluated under the VIE model. Legal entities in the P&U industry often are considered VIEs because

1. the equity holders are protected from losses or their return is capped (e.g., a put or call arrangement for assets of the entity or an arrangement that protects the equity holders from commodity price risk (fuel and electricity) and O&M risk),
2. the equity holders share power with or cede power to other parties (e.g., debt investors or another party through a PPA), or
3. the equity holders have disproportionate voting rights to their profit-sharing arrangements. See Chapter 5 for further discussion of whether a legal entity is a VIE.

#### E.5.3.1 The Business Scope Exception

The “business scope exception” exempts reporting entities from evaluating whether a legal entity that qualifies as a business under ASC 805 is a VIE unless one or more of the four conditions discussed in Section 3.4.4 apply. While legal entities in the P&U industry may meet the definition of a business under ASC 805, the reporting entity often fails to meet one or more of the four conditions that preclude the use of the exception. For example, a single-plant entity that has issued debt collateralized by the asset would generally not qualify for the business scope exception because it would meet the condition in ASC 810-10-15-17(d)(4).

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7 See discussion in Section 3.4.4.2 on ASU 2017-01, which narrowed the definition of a business. As a result of the ASU, fewer legal entities (such as single-plant entities) may meet the definition of a business on a prospective basis.
E.5.3.2 Limited Partnerships

Developers in the renewable energy sector often use limited partnerships or similar structures for tax purposes. For example, a developer of a renewable energy facility that does not generate sufficient taxable income to offset the tax incentives or investment tax credits generated from its operations may monetize these tax credits by identifying investors that are able to use the tax incentives and credits. These renewable “flip” structures are typically set up as tax pass-through entities to give the investors (i.e., tax-equity investors) the ability to use the tax benefits of the partnership. When evaluating these types of structures under ASC 810, reporting entities should assess whether they are limited partnerships (or similar structures) and, if so, whether the holders of equity at risk (typically, the limited partners) have substantive kick-out or participating rights. If such rights do not exist, the partnership would be considered a VIE. See Section 5.3.1.2 for further discussion of whether a limited partnership (or similar entity) is a VIE.

E.5.3.3 Tax Equity

The prevalence of tax equity in renewable flip structures has led to questions about whether tax equity qualifies as equity at risk. The answer can affect the VIE determination related to equity sufficiency and the requirement that equity holders (as a group) have the three characteristics of a controlling financial interest. Tax equity will generally qualify as “at risk” unless the return of the tax investor is somehow guaranteed by the partnership. Disproportionate equity distributions until a flip date, in isolation, would not constitute a guarantee of the tax investor’s return.

E.5.4 Determining Whether the Reporting Entity Is the Primary Beneficiary of a VIE

The evaluation of whether to consolidate a VIE focuses on whether the reporting entity has (1) the power to direct the activities that most significantly affect the economic performance of the VIE (power criterion) and (2) a potentially significant interest in the VIE (economics criterion). However, the determination is often based on which variable interest holder satisfies the power criterion since generally more than one variable interest holder meets the economics criterion. Determining which variable interest holder, if any, meets the power criterion can be challenging. Although a quantitative expected loss calculation is not required, an understanding of the economic performance of the entity is useful in the assessment of the purpose and design of the VIE and the risks the VIE was designed to create and pass along to its variable interest holders (see discussion below).

E.5.4.1 Risks of the Entity

When identifying the activities that most significantly affect the legal entity, the reporting entity should focus on the purpose and design of the VIE and the risks the VIE was designed to create and pass along to its variable interest holders. The evaluation should focus on how each risk affects the VIE’s economic performance, not just those risks that have a direct impact on the net income of the VIE.

This concept is best illustrated by an example involving a traditional PPA with fixed-capacity pricing (e.g., a fixed monthly capacity charge) and variable pricing designed to pass through the variable cost of production to the off-taker. In this arrangement, the capacity payment is designed to (1) reimburse the seller’s capital investment in the plant, (2) cover fixed production costs, and (3) provide a return to the equity holders. The variable price, on the other hand, is often a pure pass-through mechanism designed to pass fuel and variable O&M costs along to the off-taker without a profit adder. Accordingly, the decision to dispatch electricity from the plant does not have a direct bearing on the profitability of the VIE — the capacity payment, which is dependent only on the availability of the plant, determines the net income of the VIE. A narrow focus on only those risks that affect net income could lead a reporting entity...
to conclude that the ability to dispatch would not be considered in the analysis of which party has the power to direct the activities that most significantly affect the VIE’s economic performance because the dispatch decision does not affect earnings of the VIE.

We believe that such a conclusion would be inappropriate because it ignores the fact that the dispatch decision governs the off-taker’s variable payment obligation and therefore directly affects the VIE’s level of exposure to commodity prices that the off-taker absorbs. Note that the dispatch rights, in and of themselves, may not necessarily lead to consolidation by the off-taker. To weigh the significance of commodity-price risk in the context of the VIE’s overall risk profile, a reporting entity must consider (1) the other risks created and passed along to variable interest holders and (2) which parties have the power to direct the activities related to those risks. See Section E.5.4.3 for additional information.

Example E-5

A local utility enters into a long-term PPA with a single-plant legal entity. The PPA is a prerequisite to the legal entity’s acquisition of bank financing. The PPA is structured such that the local utility reimburses the legal entity for certain production costs, including fuel.

Although the single-plant legal entity is not a merchant operation, its risk profile is similar to that of a merchant generator. That is, the risks the legal entity is exposed to are likely to include commodity price risk (fuel and electricity), O&M risk (including efficiency and technology risk), residual value risk, remarketing risk, regulatory risk, catastrophic risk, construction risk, and, in some cases, tax risk. In this example, even though the local utility absorbs 100 percent of the legal entity’s fuel price risk, that risk is still relevant to the analysis because it is absorbed by a variable interest holder, albeit not an equity owner. This view would also apply to scenarios involving tolling arrangements in which the off-taker provides the fuel input. Like the PPA, a tolling arrangement is another example of risk allocation through contracting, but the base risks remain those of a merchant generator. Further, there is no substantive difference between the provision of the fuel by the off-taker and the billing of the off-taker by the generator for fuel it procures on a dollar-for-dollar basis.

Once the risks have been identified, the reporting entity is required to identify the activities related to those risks. It is appropriate to exclude from the analysis uncontrollable risks. On the other hand, there may be situations in which the activities related to the risks are asserted to be “outside” the entity and should be included in the analysis. See Section 4.3.10.1 for a discussion of the SEC’s views on “activities around the entity.”

The example above describes the identification of risks in a single-plant entity or merchant operation. However, the risks identified could differ depending on the nature of the legal entity. For example, there may be unique considerations for equipment-leasing entities (including those related to uninstalled gas turbines, rail cars, etc.).

E.5.4.2 Risks With No Activities

While reporting entities should consider all the VIE’s risks, the VIE may be exposed to risks that do not have direct activities related to them. Accordingly, the evaluation should focus on any substantive ongoing activities that are expected to have a significant effect on the economic performance of the VIE rather than on risks that may be significant to the legal entity but are not subject to control by any party. For example, the exposure to electricity price risk in a renewable project is a function of production, which is typically affected by external factors, such as wind volume. Similarly, the occurrence of a catastrophic loss event is a noncontrollable risk that would not affect the power analysis.

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8 In this example, it is assumed that the evaluation is being performed over the entire life of the entity. See Section 7.2.9.2 for a discussion of evaluating entities that have multiple distinct stages.
E.5.4.3 Identifying the Significant Activities

After a reporting entity has identified the risks of the legal entity that are expected to have the most significant effect on the legal entity's economic performance, the reporting entity would need to consider the level of decision making and activities related to those risks. Such decisions and related activities may include, for example, choices about when to operate the facility (dispatch rights), how to operate the facility, the purchasing of raw materials, the selling of excess output, the maintenance of the facility, the hiring and firing of employees, remarketing at the end of the PPA term, and the disposition of the plant at the end of its useful life (e.g., the decision to refurbish or dismantle the plant).

Typically, commodity price risk (electricity price risk and fuel price risk) and O&M risk will be the most significant controllable risks of a single-plant legal entity with a fossil-fuel generating asset. However, the reporting entity may need to use significant judgment in identifying the related relevant activities because the types of decisions, and the weight of those decisions, may vary on the basis of the design of legal entity being evaluated.

E.5.4.3.1 Fossil-Fuel Generating Assets

The significance of certain decisions may depend on whether the legal entity's primary asset is a fossil-fuel generating facility (e.g., a coal-fired power plant) or a renewable energy facility (e.g., a wind or solar farm). For example, commodity price risk is inherent in a fossil-fuel-powered plant's inputs (i.e., fuel) and outputs (i.e., electricity). Some have argued that because of the importance of O&M, it would generally be the plant's most significant activity. However, in certain instances (see discussion below), the opportunity to recognize enhanced (or deteriorating) returns on the basis of superior (or inferior) O&M performance (i.e., the opportunity to affect the efficiency of the generating asset) may not outweigh the activities that affect the potential volatility that results from commodity price risk. Accordingly, in those instances, we would expect more weight to be placed on the power to decide when to run the plant (i.e., dispatch) than on the power to decide how to run the plant (O&M). The fuel source and expected run profile of the facility (e.g., baseload, peaking) may be relevant in the reporting entity's assessment of the potential variability associated with commodity price risk. The nature of the off-taker's commodity exposure (e.g., full exposure to input or output price volatility as opposed to a net exposure to the spark spread) should also be considered. Finally, availability guarantees, minimum production guarantees, and guaranteed heat rates are examples of features that may need to be considered in the assessment of the potential variability associated with O&M.

A baseload plant is designed to run substantially all the time regardless of market conditions. Therefore, although a reporting entity (typically the power purchaser) may have the ability to make the dispatch decisions, the plant is not designed such that those decisions are likely to be exercised or have a significant impact on the plant's economic performance. Rather, the economic performance may be most closely associated with the cash inflows from a capacity payment. Capacity cash flows typically vary only according to the availability of the plant (i.e., a payment is “all or nothing”), and therefore O&M may be the most significant activity ensuring that the plant is available and the cash inflows are received. Accordingly, on the basis of facts and circumstances, O&M and other important decisions may most significantly affect the plant's economic performance.

On the other hand, a peaking plant is designed to be dispatched in times of peak load, when the market price of electricity is economic in comparison to the cost of producing the electricity. That is, the off-taker will dispatch when the spark spread is favorable since every dispatch decision effectively involves a purchase of fuel (e.g., natural gas) and a contemporaneous sale of electricity. If commodity price risk is the risk that most significantly affects the legal entity's economic performance, the reporting entity that

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Footnote: “Net exposure to the spark spread” means that the off-taker's contract is designed to absorb only the difference between the market price of electricity and the cost of producing that electricity.
makes dispatch decisions (e.g., the off-taker) would typically be deemed to have the power over the most significant activities of the VIE unless another variable interest holder has powers that, in the aggregate, exceed the effect of dispatch. The reporting entity should consider all facts and circumstances, including the extent to which the primary dispatch decision is affected by market economics or by the off-taker’s decisions.

In all cases, a reporting entity should document its considerations related to the design, purpose, risks, and significant activities of a fossil fuel-powered plant housed in a VIE when determining which party, if any, is the primary beneficiary of the VIE.

E.5.4.3.2 Renewable Generating Assets

If no party makes dispatch decisions, which may be the case for certain renewable energy technologies such as wind and solar farms, the analysis of the power to direct the activities that most significantly affect the VIE’s economic performance should focus on the other ongoing activities (e.g., O&M).

E.5.4.4 No Ongoing Activities

In the financial services industry, there are certain so-called “auto-pilot” structures (e.g., certain resecuritization structures) that have limited, if any, ongoing activities other than the administration of payments. Many believe that for these structures, the ongoing activities do not have a significant impact on the economic performance of the legal entity and that control over such activities is not indicative of a controlling financial interest. Consequently, design decisions and risk-and-reward profiles carry more weight in the consolidation analysis. However, such an approach is not likely to apply outside of pure financial structures since most operating entities (including those with physical assets) will generally involve some ongoing activities that are expected to have a significant impact on the economic performance of the legal entity.

When there are substantive ongoing activities that are expected to have a significant effect on the economic performance of the legal entity, little or no weight would be placed on decisions made at the legal entity’s inception as part of its design, including the location of the facility. Companies in the renewable sector will need to consider whether ongoing activities (e.g., O&M) are substantive and contribute significantly to the economic performance of the legal entity. For example, if the decisions about O&M are expected to have a significant impact on the productive output of the generating unit, these activities would be deemed to contribute significantly to the economic performance of the legal entity.

E.5.4.5 Activities Over the Life of the VIE

The evaluation of whether a reporting entity has power over a VIE should focus on the ongoing activities performed throughout the life of the VIE. Thus, variable interest holders should reassess their power related to the significant activities as their rights change or simply as their power relative to that of other variable interest holders changes over time. In other words, it is not necessary for a discrete change in power (e.g., based on a new contract) to occur for there to be a change in the primary beneficiary; the primary beneficiary could change over time as one party ceases to direct the most significant activities of the VIE (e.g., as the contract that gives the party power expires). For example, a PPA holder with dispatch rights may have power over the most significant activities of a VIE when making the consolidation assessment at inception of a long-term PPA. However, that same party may conclude that it no longer

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10The guidance in this section generally applies to single-plant legal entities in the operational phase. Before achievement of commercial operations, reporting entities should consider whether the power to direct the VIE’s most significant activities changes as the reporting entities move through discrete phases such as development and construction. In these scenarios, the relative certainty of successfully completing each stage is likely to be relevant to the analysis. See Section 7.2.9.2 for more information about assessing VIEs that go through discrete operational stages or phases of development.
has power over the most significant activities of the legal entity as the PPA expires. This may be the case when another party has agreed to purchase the plant output at expiration of the current PPA or when the equity holder will operate the plant on a merchant basis for the remaining useful life of the facility. On the other hand, further analysis may be required when the terms of the arrangement indicate that the off-taker has the ability to remain in power after the PPA expires (see discussion below of puts, calls, and term-extending options). For nonfinancial assets, depending upon the guidance that applies to them (e.g., they may be within the scope of ASC 606, ASC 610-20, ASC 810, or other U.S. GAAP), an entity should evaluate whether there are conditions that may hinder the ability to derecognize the generating facility once it has been recognized on the balance sheet through consolidation.11

In assessing power over the remaining life of the VIE, the reporting entity must consider all contractual rights and obligations, including those that will arise in the future (e.g., a fixed-price call option or a residual value guarantee on a power plant on the expiration of the PPA) pursuant to contracts in existence as of the balance sheet date. It is not appropriate to ignore these rights simply on the basis that they are not currently exercisable. These rights are often central to the design of the VIE and should not be disregarded in the primary-beneficiary analysis. The existence of such rights, in isolation, may not be determinative in the identification of the party with power over the activities that are most significant to a VIE’s economic performance, but they are often informative in the determination of which party has that power and should be incorporated into the analysis. Relevant considerations may include the pricing of the feature (e.g., in the money) and other business factors (e.g., a utility holds a call option on a facility that it needs to serve its native load). See Section 7.2.9.1 for more information about forward starting rights and the primary-beneficiary assessment.

Although forward starting rights (including puts, calls, and forward contracts) are not ignored in the consolidation analysis, it is likely that such rights (depending on their terms) have a more meaningful impact on the analysis for VIEs with a limited life or a limited range of activities. For example, a call right held by a party on another party's interest in an operating venture may not be given significant weight in the power analysis until exercisable if the other party's interest gives it the substantive ability to unilaterally make the significant decisions of the VIE until its interest is bought out. On the other hand, a future call right on an asset (e.g., power plant) of a VIE whose business revolves around that asset might be given more weight in the power analysis before becoming exercisable, particularly when the party holding the call right is already exerting some degree of power over the VIE through another variable interest (e.g., an off-taker that controls dispatch under a PPA).

### E.5.4.6 Multiple Parties Involved in Decision Making

It is important to remember that the primary-beneficiary analysis should take into account all parties that have power; a party with power over multiple significant activities may determine when those powers are aggregated that it has the power to direct the most significant activities of the legal entity. This concept is illustrated in ASC 810-10-25-38E.

#### Example E-6

Party A controls an activity that is deemed to significantly affect the economic performance of a legal entity, and Party B controls four activities, none of which individually affects the economic performance of the legal entity as significantly as the activity directed by A, but in the aggregate affect the economic performance of the legal entity more significantly than the activity controlled by A. In this example, B would have the power to direct the activities that most significantly affect the economic performance of the legal entity. This scenario might apply to an off-taker that has one significant power (e.g., dispatch) while another variable interest holder, such as the owner-operator, has several powers that are individually less significant but in the aggregate exceed the effects of the dispatch rights.

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11 There may also be unique considerations related to in-substance real estate for those entities that have not yet adopted ASC 606 and are therefore applying ASC 360-20. See Section E.5.5.1 for more details on the accounting and reporting for decreases in ownership of a subsidiary.
In identifying the significant risks and activities that affect the economic performance of a legal entity, as well as in assessing the “power to direct” those activities, a reporting entity must remember that ASC 810-10-25-38G indicates that the level of a reporting entity’s economic interest may indicate the amount of power that the reporting entity holds. If an off-taker concludes that the design of a legal entity and the overall substance of its PPA give it substantially all the benefits and obligations of plant ownership, but it also concludes that it is not the primary beneficiary of the VIE, the off-taker should carefully consider whether it has appropriately identified the risks and activities that affect the economic performance of the VIE and its powers related to such activities.

**E.5.4.7 Multiple Parties Have Power Over the Same Activity**

When multiple unrelated parties are responsible for the same significant activity or activities that most significantly affect the economic performance of different portions of the VIE, and consent is not required, a party with power over the majority of the significant activity or activities (if such party exists) has power over the VIE. To determine which party has power over the majority of the significant activities, the reporting entity will need to use judgment and consider all facts and circumstances.

[Example E-7 has been deleted.]

**E.5.4.8 Impact of Curtailment Rights**

There have been questions about the effects of curtailment rights (which are often held by off-takers in renewable PPAs) on the primary-beneficiary analysis. Such questions have included whether a curtailment right (which is effectively the inverse of a dispatch) could represent the power to direct the significant activities of a VIE. If a PPA is a variable interest or the off-taker has another variable interest in the legal entity, curtailment rights may represent the power to direct an activity of the VIE. However, in most circumstances, the effects of such rights on the economic performance of the legal entity will be relatively minor. In addition, the significance of such rights will depend on the type of curtailment rights in the PPA. Emergency curtailment is unlikely to contribute significantly to economic performance because of the remote and contingent circumstances associated with their exercise.

Further, voluntary or economic curtailment rights that are not contingent upon other circumstances are rarely invoked because the scenarios that make them economical to exercise (e.g., excessive negative locational marginal pricing at the delivery location) are fairly uncommon in most markets. In assessing the effects of these rights, reporting entities should consider the expected significance of the rights in the context of overall economic performance of the VIE. In many cases, this will dilute the effects of curtailment rights and lead to a relatively low weighting in the assessment of the power to direct.

**E.5.4.9 Impact of Liquidation and Withdrawal Rights**

In some cases, withdrawal rights are tantamount to kick-out or liquidation rights and should be treated as such. Section 7.2.10.3 discusses situations in which withdrawal rights should be considered in a manner similar to liquidation rights in the primary-beneficiary analysis. The existence of liquidation rights (or withdrawal rights that are in-substance liquidation rights) may be applicable, for example, when a VIE owned by an engineering, procurement, and construction (EPC) contractor is established to house the construction of a new generating facility and the utility has the right to exit the VIE, take the underlying assets, and hire a replacement EPC contractor to finish the construction.
E.5.4.10 Approval of Maintenance Schedules

Approval rights over planned maintenance schedules would not represent power over O&M (unless the approval rights are accompanied by other rights related to O&M decisions). Off-takers frequently have these rights but have no ability to influence the actual work done on the facility (other than requiring compliance with prudent utility practice). These rights would generally be more akin to protective rights than participating rights of the off-taker.

E.5.5 Other Items

E.5.5.1 Deconsolidation and Change in Ownership (Noncontrolling Interest Transactions)

This section discusses the guidance in ASC 360-20 on real estate transactions. ASC 360-20 was partially superseded by the new revenue standard (ASC 606) and ASC 610-20. However, if a sale of real estate is part of a sale-and-leaseback transaction, an entity would evaluate the transaction under ASC 840-40 until it adopts the new leases guidance (ASC 842). After adopting that guidance, an entity would evaluate a sale-and-leaseback transaction under ASC 842-40, which does not carry forward the linkage to the guidance in ASC 360-20. For entities that have adopted ASC 606 and ASC 610-20, ASC 360-20 continues to apply to sale-and-leaseback transactions involving real estate assets until the adoption of ASC 842. The discussion below does not apply to entities that have adopted the new revenue and leases guidance.

In addition to assessing the requirements of ASC 810, reporting entities may need to apply the guidance in ASC 360-20 for transactions that are sales of in-substance real estate even if the sales involve a business or a separate legal entity. This guidance applies equally to partial and full sales of in-substance real estate. ASC 360-20 addresses gain recognition on sales of real estate as well as balance sheet derecognition and, generally speaking, creates a high hurdle for derecognition of real estate. For example, ASC 360-20 states that if the seller of real estate has an option to repurchase the property, the property would remain on the seller’s books. This guidance may have significant consequences for the P&U industry’s application of consolidation principles (related to deconsolidation) because many single-plant entities will be deemed in-substance real estate. See Section F.2.1 for a discussion of deconsolidation and derecognition of in-substance real estate. Potential implications for developers and off-takers still subject to the guidance in ASC 360-20 include the following:

- Developers — Deconsolidation of a VIE by a developer may not necessarily lead to derecognition of the associated generating facility and is likely to involve consideration of criteria in addition to those in ASC 810. For example, even if a developer concludes that another variable interest holder has the power to direct the most significant activities over the remaining life of the legal entity and therefore concludes that the other variable interest holder would be required to consolidate the legal entity under ASC 810, the developer may be precluded from derecognizing the generating facility since it owns an asset that is in-substance real estate. In this situation, the developer would need to consider the guidance in ASC 360-20 to determine whether derecognition is appropriate. If the developer concludes that the transaction or circumstance represents a sale of in-substance real estate, it would need to consider prohibitions related to continuing involvement under ASC 360-20 before it can recognize profit on the transaction. In addition, depending on the form of the continuing involvement, ASC 360-20 may preclude derecognition of the real estate in these circumstances.

12 ASC 360-20-40-38 indicates that the transaction would be accounted for as a financing, leasing, or profit-sharing arrangement.
The considerations discussed above for developers may have implications for off-takers as well. For example, consider an off-taker that consolidates a VIE on the date it signs a long-term PPA with the legal entity. Given the requirement to continually reassess the primary beneficiary, the off-taker would monitor its power over economic performance relative to powers held by other variable interest holders on an ongoing basis. Under such an approach, the off-taker should consider whether deconsolidation is appropriate if the off-taker no longer has the power to direct the activities that have the most significant effect on the economic performance of the legal entity. However, once an off-taker consolidates, it may have to meet the criteria in ASC 360-20 to derecognize the facility if it concludes that the transaction or circumstance resulting in a change in control represents a “sale” of in-substance real estate. See Section F.2.1 for a description of when it would be appropriate to assess the deconsolidation of in-substance real estate under ASC 360-20.

In cases involving off-take agreements accounted for as leases, the guidance in ASC 840-40 on sale-leaseback arrangements may also be applicable. ASC 840-40 establishes an even higher hurdle for asset derecognition. For a legal owner (such as a developer discussed above) or an accounting owner (such as a consolidating off-taker), the accounting path to derecognition is likely to include ASC 360-20 (and possibly ASC 840-40 for the off-taker) when the transaction or circumstance resulting in a change in control represents a sale of in-substance real estate. See Section 17.6.1.1 of Deloitte’s A Roadmap to Applying the New Revenue Recognition Standard for further discussion.

Note that off-take arrangements may be affected by the issuance of ASC 842. Contracts that are, or contain, leases under ASC 840 solely because the customer receives the output of the underlying asset may no longer meet the definition of a lease under ASC 842. We expect that the contracts most likely to be affected by this change will be off-take and purchase arrangements, such as PPAs and manufacturing supply contracts. Unless those arrangements also grant the customer power through decision-making rights over the use of the asset (e.g., through dispatch rights, under which the customer determines whether, when, and how much the asset is producing), they are unlikely to be leases going forward. See Example 3-18 in Section 3.4 of Deloitte’s A Roadmap to Applying the New Leasing Standard for further discussion.

E.5.5.2 Separate Presentation

Given the prevalence of non-recourse-project financing in the P&U industry, reporting entities should ensure that they comply with the presentation requirements in ASC 810-10-45-25. Under those requirements, separate presentation on the face of the balance sheet is required for (1) assets of a consolidated VIE that can be used only to settle obligations of the VIE and (2) liabilities of a consolidated VIE for which the creditors do not have recourse to the general credit of the primary beneficiary. Such information is required to be presented gross (i.e., assets and liabilities cannot be “linked” or netted). See Section 11.1.1 for more information about separate presentation.

E.6 NFP and Health Care Entities

As discussed in Section 3.4.1, an NFP13 is not required to determine whether to consolidate a legal entity under the VIE model. An NFP that qualifies for the scope exception in ASC 810-10-15-17(a) would instead apply ASC 958-810 and ASC 954-810 for NFP and health care entities, respectively. Considerations related to applying those subsections are discussed below. In addition, the AICPA Audit and Accounting Guides Not-for-Profit Entities (Chapter 3) and Health Care Entities (Chapter 12) provide interpretive guidance on those subsections.

13 See Section 3.4.1.1 for discussion of the definition of an NFP.
E.6.1 Overview

<table>
<thead>
<tr>
<th>ASC 958-810</th>
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<tbody>
<tr>
<td>05-1 This Subtopic provides guidance on the following:</td>
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<tr>
<td>a. Reporting relationships between a not-for-profit entity (NFP) and another NFP that potentially result in consolidation</td>
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<tr>
<td>b. Reporting relationships with special-purpose entity lessors (either for-profit entities or NFPs)</td>
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<tr>
<td>c. Reporting a noncontrolling interest in an acquiree</td>
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<tr>
<td>d. Reporting relationships between an NFP and a for-profit entity that is other than a limited partnership or similar legal entity (incremental guidance only).</td>
</tr>
<tr>
<td>e. Reporting relationships between an NFP that is a general partner or a limited partner and a for-profit limited partnership or similar legal entity.</td>
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The consolidation considerations for NFPs depend on whether the NFP’s relationship is with another NFP (see Section E.6.2), a special-purpose-entity (SPE) lessor (see Section E.6.3), or a for-profit entity (see Section E.6.4). ASC 958-810 also provides guidance on presenting and disclosing noncontrolling interests (see Section E.6.5.1).
E.6.2 Reporting Relationships Between an NFP and Another NFP

The following flowchart (reproduced from ASC 958-810-55-3) can be used to analyze relationships between one or more NFPS:

ASC 958-810-55-3

START

Is the other NFP an SPE lessor that meets all the conditions in paragraph 958-810-25-8?

No

Is there a controlling financial interest? (See paragraphs 958-810-25-2 through 25-2A)

No

Does an economic interest, control, or both exist?

Yes

Does an economic interest and control exist?

Yes

Is there control via a majority voting interest in the board of the other NFP? (See paragraph 958-810-25-3)

Yes

Consolidate.

No

Consolidation is not required, but is permitted or encouraged.

Are consolidated financial statements presented?

Yes

Stop.

No

Disclose the information required by paragraph 958-810-50-2.

No

Do not consolidate.

Yes

Do not consolidate. Disclose existence and nature of relationship and related transactions (See Section 850-10-50).
E.6.2.1 Nature of the Relationship Between One or More NFPs

**ASC 958-810**

05-2 An NFP may be related to one or more other NFPs in numerous ways, including any of the following:

- a. Ownership
- b. Control
- c. Economic interest.

05-4 The nature of the relationship between the entities determines the following:

- a. Whether the financial statements of an NFP and those of another NFP should be consolidated
- b. Whether the other NFP should be reported using a method similar to the equity method (see Subtopic 958-20)
- c. The extent of the disclosure that should be required, if any.

As discussed in ASC 958-810, NFPs may be related through ownership, control, or an economic interest. The nature of the relationship determines whether one NFP should consolidate another NFP or report its interest in the NFP by using a method similar to the equity method under ASC 958-20.

### E.6.2.1.1 Ownership

**ASC 958-810**

05-3 Because NFPs may exist in various legal forms, ownership of NFPs may be evidenced in various ways. Examples include:

- a. Corporations issuing stock
- b. Corporations issuing ownership certificates
- c. Membership corporations issuing membership certificates
- d. Joint ventures
- e. Partnerships.

A parent corporation typically owns stock in a for-profit entity, whereas a sole corporate member holds (all) membership rights in an NFP.

ASC 958-810-05-3 indicates that evidence of an NFP’s ownership of another NFP can include stock or ownership certificates in an NFP corporation as well as interests in NFP joint ventures or NFP partnerships. Some NFPs may also be structured as membership corporations. In a membership corporation, the corporate decision making that is typically granted to the NFP’s board of directors is granted to the corporate members identified in the NFP’s articles of incorporation. When a membership corporation consists of a single member, that single member is referred to as the sole corporate member and is generally considered equivalent to a sole shareholder since it typically has the unilateral power to appoint and terminate the NFP’s board and dissolve the NFP.

### E.6.2.1.2 Control

ASC 958-810-20 defines control as the “direct or indirect ability to determine the direction of management and policies through ownership, contract, or otherwise.” As discussed below, an NFP may have control over another NFP through a majority voting interest or a majority voting interest in the board, as the sole corporate member, or through other means, such as a contract.
E.6.2.1.3 Economic Interest

ASC 958-810-20 defines the term “economic interest” as follows:

<table>
<thead>
<tr>
<th>ASC 958-810 — Glossary</th>
</tr>
</thead>
<tbody>
<tr>
<td>Economic Interest</td>
</tr>
<tr>
<td>A not-for-profit entity’s (NFP’s) interest in another entity that exists if any of the following criteria are met:</td>
</tr>
<tr>
<td>a. The other entity holds or utilizes significant resources that must be used for the purposes of the NFP, either directly or indirectly by producing income or providing services.</td>
</tr>
<tr>
<td>b. The NFP is responsible for the liabilities of the other entity.</td>
</tr>
<tr>
<td>See paragraph 958-810-55-6 for examples of economic interests.</td>
</tr>
</tbody>
</table>

In addition, ASC 958-810-55-6 provides some examples of economic interests, including the assignment of significant functions to another entity or residual interests held by an NFP in another NFP. However, the determination of whether an NFP has an economic interest in another NFP involves significant judgment and requires consideration of the facts and circumstances.

<table>
<thead>
<tr>
<th>ASC 958-810</th>
</tr>
</thead>
<tbody>
<tr>
<td>55-6 The following are examples of economic interests:</td>
</tr>
<tr>
<td>a. Other entities solicit funds in the name of and with the expressed or implied approval of the NFP, and substantially all of the funds solicited are intended by the contributor or are otherwise required to be transferred to the NFP or used at its discretion or direction.</td>
</tr>
<tr>
<td>b. An NFP transfers significant resources to another entity whose resources are held for the benefit of the NFP.</td>
</tr>
<tr>
<td>c. An NFP assigns certain significant functions to another entity.</td>
</tr>
<tr>
<td>d. An NFP provides or is committed to provide funds for another entity or guarantees significant debt of another entity.</td>
</tr>
<tr>
<td>e. An NFP has a right to or a responsibility for the operating results of another entity. Or upon dissolution, an NFP is entitled to the net assets, or is responsible for any deficit, of another entity.</td>
</tr>
</tbody>
</table>

Example E-8

Church P is a religious NFP corporation with over 1,000 local churches in the United States. Under P’s corporate structure, P is a legal entity, and each local church is a separate legal entity. To ensure that each local church is operating in accordance with P’s mission as a nonprofit organization, P supports the professional development of ministry leaders at the local churches as well as the growth and development of local church programs. In exchange, P is entitled to 10 percent of the general offerings that each local church receives. As a result of P’s right to 10 percent of the offerings received by each local church, P has an economic interest in each local church.

Example E-9

Foundation F is an NFP formed by School S, an NFP university, to provide estate planning services, planned giving services, and trust administration for individuals with multiple charitable interests. Foundation F has historically served as a conduit for donors to contribute to S and holds approximately $30 million in donations provided by outside donors specifically for the benefit of S. These amounts cannot be used for any other purpose by F. In addition, F and S entered into a gift agreement under which F would transfer funds from F to S over future years. The gift agreement is irrevocable, binding on and enforceable against F and S, and designed to provide S with both up-front payments and a steady stream of funds. The gift is restricted to specific purposes and is to be added to existing funds held by F for the benefit of S. Since F is committed to providing funds to S through the gift agreement as well as holding amounts for the benefit of S, S has an economic interest in F.
E.6.2.2  **Consolidation Framework for an NFP’s Relationship With Another NFP**

**ASC 958-810**

25-1 A relationship with another not-for-profit entity (NFP) can take any one of the following forms, which determines the appropriate reporting:

a. A controlling financial interest through direct or indirect ownership of a majority voting interest or sole corporate membership in the other NFP (see the following paragraph)

b. Subparagraph not used

c. Control of a related but separate NFP through a majority voting interest in the board of that NFP by means other than ownership or sole corporate membership and an economic interest in that other NFP (see paragraph 958-810-25-3)

d. An economic interest in the other NFP combined with control through means other than those listed in (a) through (c) (see paragraph 958-810-25-4)

e. Either an economic interest in the other NFP or control of the other NFP, but not both (see paragraph 958-810-25-5).

Under ASC 958-810-25-1, an NFP’s relationship with another NFP may take a number of different forms, including those noted above.

E.6.2.2.1  **Controlling Financial Interest Through a Majority Voting Interest or Sole Corporate Membership**

**ASC 958-810**

25-2 An NFP with a controlling financial interest in another NFP through direct or indirect ownership of a majority voting interest or sole corporate membership in that other NFP shall consolidate that other NFP, unless control does not rest with the majority owner or sole corporate member (for example, if the subsidiary is in legal reorganization or bankruptcy), in which case consolidation is prohibited, as discussed in paragraph 810-10-15-10. Sole corporate membership in an NFP, like ownership of a majority voting interest in a for-profit entity, shall be considered a controlling financial interest, unless control does not rest with the sole corporate member (for instance, if the other [membership] entity is in bankruptcy or if other legal or contractual limitations are so severe that control does not rest with the sole corporate member).

25-2A In some situations, certain actions require approval by a supermajority vote of the board. Such voting requirements might overcome the presumption of control by the owner or holder of a majority voting interest. For related implementation guidance, see paragraph 958-810-55-4A.

55-4A This paragraph provides implementation guidance on the application of paragraph 958-810-25-2A to situations in which certain actions require approval by a supermajority vote of the board. That paragraph states that such voting requirements might overcome the presumption of control by the owner or holder of a majority voting interest. An NFP shall exercise judgment in evaluating such situations. If supermajority voting requirements exist—for example, a specified supermajority of the board is needed to approve fundamental actions such as amending the articles of incorporation or dissolving the entity, an NFP shall consider whether those voting requirements have little or no effect on the ability to control the other entity’s operations or assets or, alternatively, whether those voting requirements are so restrictive as to call into question whether control rests with the holder of the majority voting interest. The guidance in paragraphs 810-10-25-2 through 25-14 may be helpful in considering whether the inability of the majority voting interest to unilaterally approve certain actions due to supermajority voting requirements is substantial enough to overcome the presumption of control.
When an NFP has a controlling financial interest in another NFP through either direct or indirect ownership of a majority of the voting interest or through a sole corporate membership, consolidation is required unless control does not rest with the majority owner or sole corporate member (for instance, if the other (membership) entity is in bankruptcy, or other legal or contractual limitations are so severe that control does not rest with the sole corporate member). See Sections D.1.3.2 and D.3 for further discussion of instances in which the holder of a majority voting interest lacks control. NFPs should also consider specific voting requirements (e.g., supermajority) that may overcome the presumption of control. The guidance in ASC 810-10-25-2 through 25-14 on the effect of noncontrolling rights on consolidation may help NFPs determine whether the presumption of control by the majority voting interest holder or sole corporate member has been overcome. See Section D.2 for more information about the effect of noncontrolling rights on consolidation.

Example E-10

NFP X is the sole corporate member of NFP Y and has the power to select and appoint all five directors on Y’s board. No other NFP retains corporate membership rights over Y; thus, all control rests solely with X. NFP X and Y do not hold any economic interests in each other. Therefore, X should consolidate Y in accordance with ASC 958-810-25-2, which states, “Sole corporate membership in an NFP, like ownership of a majority voting interest in a for-profit entity, shall be considered a controlling financial interest, unless control does not rest with the sole corporate member.”

Example E-11

Assume the same facts as in Example E-10 except that NFP X only has the power to select and appoint three out of five directors on Y’s board. NFP Z has the power to select and appoint the remaining two directors on Y’s board. A unanimous vote of all five directors on Y’s board is needed to approve fundamental actions, including selecting, terminating, and setting the compensation of management and establishing operating and capital decisions (including budgets). NFP X determines that these unanimous voting requirements related to the fundamental actions of NFP Y restrict NFP X’s ability to control NFP Y’s operations. Therefore, control does not rest with NFP X as the sole corporate member in NFP Y.

E.6.2.2.2 Majority Voting Interest in the Board

ASC 958-810

25-3 In the case of control of a related but separate NFP through a majority voting interest in the board of the other NFP by means other than ownership or sole corporate membership and an economic interest in that other NFP, consolidation is required, unless control does not rest with the holder of the majority voting interest, in which case consolidation is prohibited. An NFP has a majority voting interest in the board of another entity if it has the direct or indirect ability to appoint individuals that together constitute a majority of the votes of the fully constituted board (that is, including any vacant board positions). Those individuals are not limited to the NFP’s own board members, employees, or officers. For implementation guidance on a majority voting interest in the board of another entity, see paragraph 958-810-55-5.

55-5 A majority voting interest in the board of another entity, as referred to in paragraph 958-810-25-3, is illustrated by the following example. Entity B has a five-member board, and a simple voting majority is required to approve board actions. Entity A will have a majority voting interest in the board of Entity B if Entity A has the ability to appoint three or more of Entity B’s board members. If three of Entity A’s board members, employees, or officers serve on the board of Entity B but Entity A does not have the ability to require that those members serve on the Entity B board, Entity A does not have a majority voting interest in the board of Entity B.
Generally, a majority voting interest in an NFP will result when the NFP's articles of incorporation grant the right to appoint a majority of its fully constituted governing board (including any vacant board positions) to another NFP. However, if a majority of an NFP's board consists of another NFP's board members, employees, or officers, that NFP would not have a majority voting interest in the board if it lacked the ability to require that those members serve on the NFP's board.

When control by an NFP of a related but separate NFP is through (1) a majority voting interest in the board of the NFP by means other than ownership or sole corporate membership and (2) an economic interest in the other NFP, consolidation is required unless control does not rest with the holder of the majority voting interest in the board. This requirement is similar to that related to a majority voting interest or sole corporate membership discussed in Section E.6.2.2.1, except that it involves voting interests conveyed through means other than ownership (either direct or indirect). The guidance in ASC 810-10-25-2 through 25-14 on the effect of noncontrolling rights on consolidation may help an NFP determine whether the presumption of control by the holder of the majority voting interest in the board has been overcome (see ASC 958-810-55-4A and Section E.6.2.2.1). See Section D.2 for further discussion of the effect of noncontrolling rights on consolidation.

Paragraph 3.78 of Not-for-Profit Entities provides the following example of control by a majority voting interest in the board of another NFP:

An NFP may be related to another NFP that performs political activities that the reporting entity does not wish to perform, perhaps because performing those activities may threaten the reporting entity's tax exempt status, the reporting entity is precluded from conducting such activities, or for other reasons. For example, a membership entity may establish and sponsor a political action committee (PAC) whose mission is to further the interests of the membership entity. The resources held by the PAC are used for the purposes of the membership entity and the governing board of the PAC is appointed by the board of the membership entity. In the circumstances described, both control and economic interest are present and the PAC should be consolidated. Control through a majority voting interest in the board of the PAC exists because the governing board of the PAC is appointed by the board of the membership entity. An economic interest exists because the PAC holds significant resources that must be used for the purposes of the membership entity.

### E.6.2.2.3 Control by Other Means

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25-4 Control of a related but separate NFP in which the reporting entity has an economic interest may take forms other than majority ownership interest, sole corporate membership, or majority voting interest in the board of the other entity; for example, control may be through contract or affiliation agreement. In circumstances such as these, consolidation is permitted but not required. Consolidation is encouraged if both of the following criteria are met:

a. The reporting entity controls a separate NFP in which it has an economic interest and that control is not control through either of the following means:

1. A controlling financial interest in the other NFP through direct or indirect ownership of a majority voting interest
2. A majority voting interest in the board of the other NFP.

b. Consolidation would be meaningful.
When an NFP holds both (1) an economic interest (see Section E.6.2.1.3) in another NFP and (2) control through means other than a majority ownership interest, sole corporate membership, or a majority voting interest in the board, consolidation is permitted but not required. Other means of control may include a contract or affiliation agreement (see Section D.3.4 for further discussion of situations in which an entity may be controlled through a contract). Consolidation is encouraged in these circumstances if it would be meaningful. Such determination involves judgment and requires consideration of the facts and circumstances. The indicators in paragraph 3.118 of Not-for-Profit Entities used to help an NFP determine whether to consolidate a for-profit entity can also help it determine whether to consolidate another NFP. Considerations related to this determination include, but are not limited to, the following:

- “The size of the for-profit subsidiary in relation to the NFP parent.”
- “The activities of the for-profit subsidiary in relation to the mission of the NFP parent.”
- Other quantitative and qualitative considerations relevant to the financial statement users.

E.6.2.2.4 Control or an Economic Interest, but Not Both

Consolidation is prohibited if an NFP holds either an economic interest in another NFP or control of the other NFP, but not both. However, there may be certain scenarios in which an NFP should consolidate a legal entity when it holds an economic interest and does not have direct control of that legal entity’s board. It is important to view the ownership interests and rights to the residual interest as indicators of indirect control when direct control of the board is not present. An NFP is presumed to have indirect control, and should therefore consolidate a legal entity, if the NFP possesses the following:

- An ownership interest of 100 percent of the legal entity or the right to the residual interest in it.
- Representation on the board of the legal entity when no party directly controls the board.

See Section D.1.3.1, which discusses control in the absence of a majority voting interest, for additional factors to consider in the determination of substantive control of a legal entity.
E.6.3 SPE Lessors

ASC 958-810

25-8 Notwithstanding the guidance in this Subtopic, an NFP that is engaged in leasing transactions with a special-purpose-entity (SPE) lessor shall consider whether it should consolidate such lessor. Specifically, such an NFP shall consolidate an SPE lessor if all of the following conditions exist:

a. Substantially all of the activities of the SPE involve assets that are to be leased to a single lessee.

b. The expected substantive residual risks and substantially all the residual rewards of the leased asset(s) and the obligation imposed by the underlying debt of the SPE reside directly or indirectly with the lessee through means such as any of the following:
   1. The lease agreement
   2. A residual value guarantee through, for example, the assumption of first-dollar-of-loss provisions
   3. A guarantee of the SPE's debt
   4. An option granting the lessee a right to do either of the following:
      i. To purchase the leased asset at a fixed price or at a defined price other than fair value determined at the date of exercise
      ii. To receive any of the lessee's sales proceeds in excess of a stipulated amount.

c. The owner (or owners) of record of the SPE has not made an initial substantive residual equity capital investment that is at risk during the entire lease term. This criterion shall be considered met if the majority owner (or owners) of the lessor is not an independent third party, regardless of the level of capital investment.

25-10 If all of the conditions in paragraph 958-810-25-8 exist, the assets, liabilities, results of operations, and cash flows of the SPE shall be consolidated in the lessee's financial statements. This conclusion shall be applied to SPEs that are established for both the construction and subsequent lease of an asset for which the lease would meet all of the conditions in paragraph 958-810-25-8. In those cases, the consolidation by the lessee shall begin at lease inception rather than the beginning of the lease term. For related implementation guidance, see paragraphs 958-810-55-7 through 55-16 and 958-840-55-1.

Pending Content (Transition Guidance: ASC 842-10-65-1)

25-10 If all of the conditions in paragraph 958-810-25-8 exist, the assets, liabilities, results of operations, and cash flows of the SPE shall be consolidated in the lessee's financial statements. This conclusion shall be applied to SPEs that are established for both the construction and subsequent lease of an asset for which the lease would meet all of the conditions in paragraph 958-810-25-8. In those cases, the consolidation by the lessee shall begin at lease inception rather than the beginning of the lease term. For related implementation guidance, see paragraphs 958-810-55-7 through 55-16.

An NFP that is engaged in leasing transactions with an SPE lessor must apply the consolidation guidance in ASC 958-810 to determine whether it should consolidate the SPE lessor.

An NFP is required to consolidate an SPE lessor if all of the following three conditions are met:

• Substantially all the activities of the SPE involve assets that are to be leased to a single lessee (see Section E.6.3.1).

• The expected substantive residual risks and substantially all the residual rewards of the leased asset(s) and the obligation imposed by the underlying debt of the SPE reside directly or indirectly with the lessee (see Section E.6.3.2).

• The SPE's owner or owners of record have not made an initial substantive residual equity capital investment that is at risk during the entire lease term. This criterion would be considered met if the majority owner or owners of the lessor are not independent third parties, regardless of the level of capital investment (see Section E.6.3.3).
ASC 958-840 also contains guidance on NFP transactions with SPE lessors related to leases that do not meet all three conditions for consolidation.

Note that in February 2016, the FASB issued ASU 2016-02 (ASC 842), which requires a lessee to account for most leases on its balance sheet, including those leases that have historically been accounted for as operating leases. ASC 842 changes the definition of certain terms in ASC 958-810, such as lease term, and therefore reporting entities should determine the effect of the adoption of ASC 842 on their application of the consolidation guidance on SPE lessors. See Deloitte’s *A Roadmap to Applying the New Leasing Standard* for further discussion.

### E.6.3.1 Substantially All the Activities of the SPE Involve Assets to Be Leased to a Single Lessee

<table>
<thead>
<tr>
<th>ASC 958-810</th>
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<tbody>
<tr>
<td><strong>55-8</strong> This implementation guidance addresses the application of paragraph 958-810-25-8(a) to a transaction involving all of the following characteristics:</td>
</tr>
<tr>
<td>a. An SPE is formed to acquire two separate properties that are to be leased to two unrelated lessees.</td>
</tr>
<tr>
<td>b. The two asset acquisitions are financed with the proceeds from two nonrecourse borrowings that do not contain cross-collateral provisions; that is, in the event of default, each borrowing is collateralized only by a pledge of the respective assets leased to a single lessee and an assignment of the respective lease payments under the related lease.</td>
</tr>
<tr>
<td>c. The SPE has no assets other than the leased properties and the related leases.</td>
</tr>
<tr>
<td><strong>55-9</strong> The use of nonrecourse debt with no cross-collateral provisions effectively segregates the cash flows and assets associated with the two leases and, therefore, in substance, creates two SPEs. For purposes of applying the provisions of paragraph 958-810-25-8, each lessee would be considered to have satisfied the condition in paragraph 958-810-25-8(a). For either lessee to be in a position of not satisfying that condition, the assets of the SPE (subject to the two leases) would need to be commingled such that, in the event of default, both lenders to the SPE would have equal rights (that is, pari passu) to the cash flows and assets related to both leases of the SPE. In this regard, the amounts of the cash flows from each lease and the fair values of the individual assets subject to the leases must represent more than a minor amount (that is, more than 10 percent) of the aggregate cash flows from all leases and the aggregate fair value of all assets of the SPE, respectively.</td>
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</table>

The “substantially all” threshold is high and is applied in a manner similar to the business scope exception discussed in Section 3.4.4.7 and the VIE determination discussed in Section 5.4.2. A reporting entity should consider both quantitative and qualitative factors in evaluating whether substantially all the activities of the SPE involve assets that are to be leased to a single lessee. As the guidance above demonstrates, there may be circumstances in which the condition in ASC 958-810-25-8(a) is satisfied even when there are multiple properties in a single SPE lessor with multiple lessees.
E.6.3.2  **Expected Substantive Residual Risks — Substantially All the Residual Rewards of the Leased Asset(s) and the Obligation Imposed by the Underlying Debt of the SPE Reside Directly or Indirectly With the Lessee**

This condition may be satisfied as a result of any of the following:

- The lease agreement.
- A residual value guarantee through, for example, the assumption of first-dollar-of-loss provisions.
- A guarantee of the SPE’s debt.
- An option granting the lessee a right to do either of the following:
  - Purchase the leased asset at a fixed price or at a defined price other than fair value determined as of the date of exercise.
  - Receive any of the lessor’s sales proceeds in excess of a stipulated amount.

E.6.3.3  **SPE Owner Has Not Made an Initial Substantive Residual Equity Capital Investment at Risk During the Entire Lease Term**

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<th>ASC 958-810</th>
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25-9 To satisfy the at-risk requirement in item (c) in the preceding paragraph, an initial substantive residual equity capital investment shall meet all of the following conditions:

a. It represents an equity interest in legal form.

b. It is subordinate to all debt interests.

c. It represents the residual equity interest during the entire lease term.

55-10 This implementation guidance addresses the level at which an entity should apply the conditions in paragraph 958-810-25-8 to a transaction having all of the following characteristics:

a. Sponsor forms an SPE, SPE A.

b. SPE A acquires property with the proceeds from nonrecourse debt and leases the property to Lessee A.

c. SPE A has no other activities and the terms of the lease satisfy the condition in paragraph 958-810-25-8(b), which discusses the residual risks and rewards associated with the leased assets and related debt.

d. The sponsor owns 100 percent of SPE A’s voting common stock.

e. The sponsor contributes the common stock of SPE A to capitalize another SPE (SPE B) that is formed to own and lease assets to Lessee B.

f. The other assets of SPE B are financed entirely with nonrecourse debt and are subject to a lease, the terms of which also satisfy the condition in paragraph 958-810-25-8(b).

Thus, SPE B, which is wholly owned by the sponsor, becomes the parent of SPE A.

55-11 Consistent with the implementation guidance in paragraph 958-810-55-8 that addresses multiple properties within a single SPE, the conditions set forth in paragraph 958-810-25-8 shall be applied at the lowest level at which the parties to a transaction create an isolated entity, whether by contract or otherwise. Therefore, in the situation described in the preceding paragraph, the test for compliance with the condition in paragraph 958-810-25-8(a) should be applied to the parent-only financial statements of SPE B.
ASC 958-810 (continued)

55-12 In the transaction described in paragraph 958-810-55-10, assume the assets of SPE B will include the common stock of SPE A and the assets leased to Lessee B. Ownership of the stock of another SPE that is engaged in leasing property would not constitute an activity contemplated by the condition in paragraph 958-810-25-8(a). Accordingly, in this situation, the lessee shall consider that condition to be satisfied in evaluating the activities of SPE B. In addition, the sponsor’s contribution of the stock of SPE A to capitalize SPE B shall not be considered an initial substantive residual equity capital investment, as contemplated by the condition in paragraph 958-810-25-8(c), because a sponsor’s investment shall not be used to capitalize more than one SPE for purposes of applying that condition.

Payments to Equity Owners of an SPE During the Lease Term

55-13 The characterization of any payments made by the SPE-lessor to its owners of record shall be based on the SPE’s GAAP basis financial statements. That is, distributions of the SPE-lessor’s GAAP basis change in net assets shall be considered a return on equity capital, but any distribution in excess of previously undistributed GAAP change in net assets shall be considered a return of equity capital, which would reduce the amount of the equity capital investment that is at risk. If the amount of the equity capital investment is reduced below the minimum amount required as a result of a distribution in excess of previously undistributed GAAP change in net assets, the owner of record would have to make an additional investment to continue to avoid the condition in paragraph 958-810-25-8(c). An owner of record would not be required to make an additional equity capital investment if residual equity capital is reduced below the minimum amount required because of losses recorded by the SPE in accordance with generally accepted accounting principles.

Fees Paid to Owners of Record of an SPE

55-14 Paragraph 840-10-25-6(e) states that, for a lessee, minimum lease payments include fees that are paid by the lessee to the owners of the special-purpose entity for structuring the lease transaction. Paragraph 840-10-25-6(e) states that such fees shall be included as part of minimum lease payments (but shall not be included in the fair value of the leased property) for purposes of applying the 90 percent test in paragraph 840-10-25-1(d). With respect to the SPE and the application of the guidance in paragraph 958-810-25-8, the fees shall be considered a return of the owners’ initial equity capital investment. To the extent that the fees reduce the equity capital investment below the minimum amount required, the owners of record would not be considered to have a substantive residual equity capital investment that is at risk during the entire term of the lease.

Pending Content (Transition Guidance: ASC 842-10-65-1)

55-14 Paragraph 842-10-30-5(e) states that, for a lessee, lease payments include fees that are paid by the lessee to the owners of the special-purpose entity for structuring the lease transaction. Paragraph 842-10-30-5(e) states that such fees shall be included as part of lease payments (but shall not be included in the fair value of the underlying asset) for purposes of applying the criterion in paragraph 842-10-25-2(d). With respect to the SPE and the application of the guidance in paragraph 958-810-25-8, the fees paid by the lessee to the owners of the SPE shall be considered a return of the owners’ initial equity capital investment. To the extent that the fees reduce the equity capital investment below the minimum amount required, the owners of record would not be considered to have a substantive residual equity capital investment that is at risk during the entire term of the lease.
 ASC 958-810 (continued)

Source of Initial Minimum Equity Investment

55-15 If the source of the funds used to make the initial minimum equity investment in an SPE lessor is financed with nonrecourse debt that is collateralized by a pledge of the investment, the investment shall not meet the at-risk requirement in paragraph 958-810-25-8(c). Similarly, that at-risk requirement shall not be met if the owners purchased residual insurance or obtained a residual guarantee in an amount that would ensure recovery of their equity investment. If the initial minimum equity investment is financed with recourse debt from a party not related to the lessee, the owners (borrowers) shall have other assets at risk to support the borrowing to avoid the condition in paragraph 958-810-25-8(c). Thus, if the loans were full recourse loans and if the fair value of the residual equity investment serves as collateral for the debt, the lessor-owner shall be considered at risk to the extent that the owners of record are liable for any decline in the fair value of the residual interest and have, and are expected to continue to have during the term of the lease, other significant assets, in addition to and of a value that exceeds their equity investment, that are at risk.

Payment to Owners of Record of an SPE Before the Lease Term

55-16 In some build-to-suit lease transactions involving SPEs, the lease or related construction agreement provides that the SPE will construct, or cause to be constructed, the property that is to be leased. The terms of the construction or lease agreements provide that payments are to be made by the SPE to the owners of record during the construction period, which, in some cases, may be several years. Such payments generally are made to provide the owners of record with a cash yield on their equity capital investments. Payments made by the SPE to the owners of record of the SPE during the construction period shall be deemed to be a return of their initial equity capital investment as opposed to a return on their equity capital investment. To the extent that those payments reduce the equity capital investment below the minimum amount required under paragraph 958-810-25-8, the owners of record of the SPE shall not be considered to have made an initial substantive residual equity capital investment that is at risk during the entire lease term.

To evaluate whether this condition is satisfied, an NFP must first determine whether the SPE owner's residual equity capital investment is at risk. The SPE owner's residual equity capital investment is at risk if (1) it is legal-form equity, (2) it is subordinate to all debt interests, and (3) it represents the residual equity interest during the entire lease term. The NFP should consider the source of the funds used by the SPE owner to make the initial minimum equity investment in an SPE lessor as well as any other agreements entered into by the SPE owner. For instance, if the SPE owner's investment is financed with nonrecourse debt collateralized by a pledge of the investment, or if the SPE owner purchased residual insurance or obtained a residual guarantee in an amount that would ensure recovery of its equity investment, the investment would not meet the at-risk requirement. In addition, if the source of funds is recourse debt from a party unrelated to the lessee, the SPE owner must have other assets at risk to support the borrowing.

Paragraph 3.110 of Not-for-Profit Entities provides the following guidance on the minimum acceptable investment that would qualify as an initial, substantive, residual equity capital investment:

FinREC believes that 3% is the minimum acceptable investment to qualify as an initial, substantive, residual equity capital investment. A greater investment may be necessary depending on the facts and circumstances, including the credit risk associated with the lessee and market risk factors associated with the leased property. For example, the cost of borrowed funds for the transaction might be indicative of the risk associated with the transaction and whether an equity investment greater than 3% is needed. Additional information about the application of the preceding criteria and guidance for consolidation of the SPE is located in FASB ASC 958-840.
Any payments made by the SPE-lessor to its owners of record that are considered returns of investment (on the basis of the SPE's GAAP-basis financial statements) would reduce the amount of the equity capital investment at risk. Fees paid by the lessee to the owners of the SPE for structuring the lease transaction, and payments made by the SPE to the owners of record during the construction period (in some build-to-suit lease transactions), are deemed returns of investment and therefore would also reduce the amount of the equity capital investment at risk. If the amount of the equity capital investment is reduced below the minimum amount required as a result of these returns of investment, the owners of record would not be considered to have a substantive residual equity capital investment at risk during the entire term of the lease unless the owners make an additional investment.

E.6.4 Reporting Relationships Between NFPs and For-Profit Entities

ASC 958-810

15-4 Additional guidance for reporting relationships between NFPs and for-profit entities resides in the following locations in the Codification:

a. An NFP with a controlling financial interest through direct or indirect ownership of a majority voting interest in a for-profit entity that is other than a limited partnership or similar legal entity shall apply the guidance in the General Subsections of Subtopic 810-10. However, in accordance with paragraph 810-10-15-17, NFPs are not subject to the Variable Interest Entities Subsections of that Subtopic.

b. An NFP that is a general partner or a limited partner of a for-profit limited partnership or a similar legal entity (such as a limited liability company that has governing provisions that are the functional equivalent of a limited partnership) shall apply the guidance in paragraphs 958-810-25-11 through 25-29 and 958-810-55-16A through 55-16I. However, the guidance in those paragraphs does not apply to the following:

1. A general partner or a limited partner that reports its partnership interest at fair value in accordance with (e)

2. Entities in industries, such as the construction or extractive industries, in which it is appropriate for a general partner to use the pro rata method of consolidation for its investment in a limited partnership (see paragraph 810-10-45-14).

c. An NFP that owns 50 percent or less of the voting stock in a for-profit entity shall apply the guidance in Subtopic 323-10 unless that investment is reported at fair value in conformity with the guidance described in (e).

d. An NFP with a more than minor noncontrolling interest in a for-profit real estate partnership, limited liability company, or similar legal entity shall report its noncontrolling interests in such entities using the equity method in accordance with the guidance in Subtopic 970-323 unless that interest is reported at fair value in conformity with the guidance described in (e). An NFP shall apply the guidance in paragraph 970-810-25-1 to determine whether its interests in a general partnership are controlling financial interests or noncontrolling interests. An NFP shall apply the guidance in paragraphs 958-810-25-11 through 25-29 and 958-810-55-16A through 55-16I to determine whether its interests in a for-profit limited partnership, limited liability company, or similar legal entity are controlling financial interests or noncontrolling interests. An NFP shall apply the guidance in paragraph 323-30-35-3 to determine whether a limited liability company should be viewed as similar to a partnership, as opposed to a corporation, for purposes of determining whether noncontrolling interests in a limited liability company or a similar legal entity should be accounted for in accordance with Subtopic 970-323 or Subtopic 323-10.

e. An NFP may be required to report an investment described in (c) at fair value in conformity with paragraph 958-320-35-1, or may be permitted to make an election in accordance with paragraph 825-10-25-1. In addition, NFPs other than those within the scope of Topic 954 may be permitted to report the investments described in (b), (c), or (d) at fair value in conformity with Section 958-325-35.
Additional guidance for reporting relationships between NFPs and for-profit entities resides in the following locations in the Codification:

a. An NFP with a controlling financial interest through direct or indirect ownership of a majority voting interest in a for-profit entity that is other than a limited partnership or similar legal entity shall apply the guidance in the General Subsections of Subtopic 810-10. However, in accordance with paragraph 810-10-15-17, NFPs are not subject to the Variable Interest Entities Subsections of that Subtopic.

b. An NFP that is a general partner or a limited partner of a for-profit limited partnership or a similar legal entity (such as a limited liability company that has governing provisions that are the functional equivalent of a limited partnership) shall apply the guidance in paragraphs 958-810-25-11 through 25-29 and 958-810-55-16A through 55-16I. However, the guidance in those paragraphs does not apply to the following:
   1. A general partner or a limited partner that reports its partnership interest at fair value in accordance with (e)
   2. Entities in industries, such as the construction or extractive industries, in which it is appropriate for a general partner to use the pro rata method of consolidation for its investment in a limited partnership (see paragraph 810-10-45-14).

c. An NFP that owns 50 percent or less of the voting stock in a for-profit entity shall apply the guidance in Subtopic 323-10 unless the investment is measured at fair value in accordance with applicable GAAP, including the guidance described in (e). If the NFP is unable to exercise significant influence, the NFP shall apply the guidance for equity securities in Topic 321.

d. An NFP with a more than minor noncontrolling interest in a for-profit real estate partnership, limited liability company, or similar legal entity shall report its noncontrolling interests in such entities using the equity method in accordance with the guidance in Subtopic 970-323 unless that interest is reported at fair value in accordance with applicable GAAP, including the guidance described in (e). An NFP shall apply the guidance in paragraph 970-810-25-1 to determine whether its interests in a general partnership are controlling financial interests or noncontrolling interests. An NFP shall apply the guidance in paragraphs 958-810-25-11 through 25-29 and 958-810-55-16A through 55-16I to determine whether its interests in a for-profit limited partnership, limited liability company, or similar legal entity are controlling financial interests or noncontrolling interests. An NFP shall apply the guidance in paragraph 323-30-35-3 to determine whether a limited liability company should be viewed as similar to a partnership, as opposed to a corporation, for purposes of determining whether noncontrolling interests in a limited liability company or a similar legal entity should be accounted for in accordance with Subtopic 970-323 or Subtopic 323-10.

e. An NFP that is not within the scope of Topic 954 on health care entities may elect to report the investments described in (b) through (d) and paragraph 958-325-15-2 at fair value, with changes in fair value reported in the statement of activities, provided that all such investments are measured at fair value.

ASC 958-810-55-4 contains a flowchart\(^{14}\) (included below), which can be used to analyze relationships between NFPs and for-profit entities.

\(^{14}\) Once the guidance in ASU 2016-01 on the recognition and measurement of financial assets and liabilities is effective (i.e., fiscal years beginning after December 15, 2017, for a public business entity, and December 15, 2018, for all other entities), the discussion related to ASC 958-320 in the flowchart will instead refer to ASC 958-321. Further, the flowchart has been updated for ASU 2017-02, which became effective for NFPs for fiscal years beginning after December 15, 2016, and interim periods within fiscal years beginning after December 15, 2017. The changes do not affect the consolidation analysis performed by an NFP.
The following flowchart and related footnote indicate the order in which an NFP applies the guidance elsewhere in the Codification to determine the accounting for its relationship with a for-profit entity.

* According to paragraph 323-30-35-3, a limited liability company that maintains a specific ownership account for each investor — similar to a partnership capital account structure — should be viewed as similar to an investment in a limited partnership for purposes of determining whether a noncontrolling investment in a limited liability company should be accounted for using the cost method or the equity method.

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*Appendix E — Industry-Specific Guidance*
As discussed below, ASC 958-810-15-4 specifies that NFPs should also apply other relevant ASC guidance on reporting relationships between NFPs and for-profit entities.

**E.6.4.1 NFP With a Controlling Financial Interest in a For-Profit Entity**

An NFP with a controlling financial interest in a for-profit entity through direct or indirect ownership of a majority voting interest in that entity should apply the voting interest entity model in the same manner as any for-profit entity. Under the voting interest entity model, a controlling financial interest typically exists when a reporting entity owns more than 50 percent of the outstanding voting shares of another entity. However, there are exceptions to this general principle. See Appendix D for more information about the application of the voting interest entity model.

**E.6.4.2 NFP That Is a General Partner of a For-Profit Limited Partnership or a Similar Entity**

In response to questions from stakeholders on when NFPs that are general partners should consolidate for-profit limited partnerships (or similar entities), the FASB issued ASU 2017-02 in January 2017. The ASU:

- Amends the consolidation guidance in ASC 958-810 to retain the accounting under which an NFP that is a general partner is presumed to control a for-profit limited partnership or similar entity, regardless of the extent of the general partner’s ownership interest, unless the limited partners are able to exercise substantive kick-out or participating rights. The definitions of substantive kick-out and participating rights are consistent with those used in the definition of voting interest entity in ASC 810-10 (see Section 2.4, Section 2.6, and Appendix D for more information).

- Adds new guidance to ASC 958-810 on when an NFP limited partner should consolidate a for-profit limited partnership. Under the new guidance, a limited partner that owns, either directly or indirectly, more than 50 percent of the limited partnership kick-out rights is deemed to have a controlling financial interest and must consolidate the limited partnership. However, if noncontrolling limited partners have substantive participating rights, a limited partner with a majority of kick-out rights would not have a controlling financial interest.

**E.6.4.3 NFP That Owns 50 Percent or Less of the Voting Stock in a For-Profit Business Entity**

An NFP that owns 50 percent or less of the voting stock in a for-profit business entity should apply ASC 323-10 unless it reports the investment at fair value (see Section E.6.4.5).

**E.6.4.4 NFP With More Than a Minor Interest in a For-Profit Real Estate Partnership, Limited Liability Company, or Similar Entity**

ASC 958-810-15-4(d) discusses the accounting for NFPs with more than a minor interest in a for-profit real estate partnership, limited liability company, or similar entity. To determine whether their interests are considered more than minor, many NFPs refer to ASC 323-30-S99-1, which reflects the SEC staff’s understanding that practice generally has viewed investments of more than 3 percent to 5 percent to be more than minor.

If an NFP has more than a minor interest in a for-profit real estate partnership, limited liability company, or similar entity, it should determine whether it holds a controlling financial interest or a noncontrolling interest in the for-profit real estate entity. ASC 970-810-25-1 through 25-3 provide the guidance below to help NFPS make this determination.
### ASC 970-810

#### General Partnerships

**25-1** A general partnership that is controlled, directly or indirectly, by an investor is, in substance, a subsidiary of the investor. Paragraph 810-10-15-8 states that the usual condition for a controlling financial interest is ownership of a majority voting interest, and, therefore, as a general rule ownership by one entity, directly or indirectly, of over 50 percent of the outstanding voting shares of another entity is a condition pointing toward consolidation. However, if partnership voting interests are not clearly indicated, a condition that would usually indicate control is ownership of a majority (over 50 percent) of the financial interests in profits or losses (see paragraphs 970-323-35-16 through 35-17). Paragraph 810-10-15-8 states that the power to control may also exist with a lesser percentage of ownership, for example, by contract, lease, agreement with other stockholders, or by court decree. The power to control may also exist with a lesser percentage of ownership by agreement with other partners.

**25-2** On the other hand, the majority interest holder may not control the entity if one or more of the other partners have substantive participating rights that permit those other partners to effectively participate in certain significant financial and operating decisions that are made in the ordinary course of business. The determination of whether the rights of the other partners are substantive participating rights shall be evaluated in accordance with the guidance for substantive participating rights in paragraphs 810-10-25-2 through 25-14. If the other partners have substantive participating rights, the presumption of control by the majority interest holder is overcome. A controlling investor shall account for its investment under the principles of accounting applicable to investments in subsidiaries. Accordingly, interentity profits and losses on assets remaining within the group shall be eliminated. A noncontrolling investor in a general partnership shall account for its investment by the equity method and should be guided by the provisions of Topic 323.

#### Limited Partnerships

**25-3** If a limited partnership does not meet the conditions in paragraph 810-10-15-14 and, therefore, is not a variable interest entity, limited partners shall evaluate whether they have a controlling financial interest according to paragraph 810-10-15-8A. The guidance in Subtopic 810-10 on consolidation shall be used to determine whether any limited partners control the limited partnership:

a. If no single partner controls the limited partnership, the general and limited partners shall apply the equity method of accounting to their interests, except for instances when a limited partner's interest is so minor that the limited partner may have virtually no influence over partnership operations and financial policies (see paragraph 323-30-599-1).

b. Subparagraph superseded by Accounting Standards Update No. 2015-02.

c. If a single limited partner controls the limited partnership, that limited partner shall consolidate the limited partnership and apply the principles of accounting applicable for investments in subsidiaries in Topic 810.

In accordance with the guidance above, if the for-profit real estate entity is a general partnership, an NFP should apply the voting interest entity model to determine whether it holds a controlling financial interest in the general partnership (see Appendix D). Similarly, if the for-profit real estate entity is a limited partnership, an NFP should apply the voting interest entity model to determine whether any of the limited partners control the limited partnership (see Appendix D).

If an NFP does not have a controlling financial interest in the for-profit real estate entity, the NFP should first apply ASC 323-30-35-3 to determine whether it should consider an interest in a limited liability company as an interest in a partnership instead of a corporation. ASC 323-30-35-3 (pending content) specifies that “[a]n investment in a limited liability company that maintains a specific ownership account for each investor — similar to a partnership capital account structure — shall be viewed as similar to an investment in a limited partnership for purposes of determining whether a noncontrolling investment in a limited liability company shall be accounted for in accordance with the guidance in Topic 321 or the equity method.”
If an NFP has a noncontrolling interest in a partnership or a limited liability company that is similar to a partnership under ASC 323-30-35-3, the NFP should use the equity method in accordance with ASC 970-323 to report such noncontrolling interest except when it elects to report the interest at fair value under ASC 825-10 (see Section E.6.4.5 below).

If an NFP has a noncontrolling interest in a limited liability company that is similar to a corporation, the NFP should use the equity method in accordance with ASC 323-10 to report the noncontrolling interest except when it elects to report such interest at fair value under ASC 825-10 (see Section E.6.4.5 below).

**E.6.4.5 Reporting an NFP’s Investment at Fair Value**

If consolidation is not required, an NFP with an investment in a for-profit entity could (1) be required to carry its investment at fair value (if it is an equity security with a readily determinable fair value or any debt security) or (2) elect the fair value option in accordance with ASC 825-10-25-1.

**E.6.5 Presentation and Disclosures for NFPs**

**E.6.5.1 Presentation of Noncontrolling Interests**

If the conditions for consolidation discussed in Sections E.6.2.2.1, E.6.2.2.2, or E.6.2.2.3 are met, an NFP would not reflect a noncontrolling interest in its consolidated financial statements for the portion of the board of directors the NFP does not control, because the NFP is the only entity that holds an ownership interest.

When noncontrolling interests of consolidated subsidiaries are required to be presented, they should be clearly identified and included as a separate component of net assets in the NFP’s consolidated financial statements. ASC 958-810-55-17 through 55-25 illustrate how an NFP may present and disclose noncontrolling interests in accordance with ASC 958-810.

The effects of donor-imposed restrictions on a partially owned subsidiary’s net assets should also be reported. ASC 958-810-20 defines a donor-imposed restriction as follows:
**Donor-Imposed Restriction**

A donor stipulation (donors include other types of contributors, including makers of certain grants) that specifies a use for a contributed asset that is more specific than broad limits resulting from the following:

- a. The nature of the not-for-profit entity (NFP)
- b. The environment in which it operates
- c. The purposes specified in its articles of incorporation or bylaws or comparable documents for an unincorporated association.

Some donors impose restrictions that are temporary in nature, for example, stipulating that resources be used after a specified date, for particular programs or services, or to acquire buildings or equipment. Other donors impose restrictions that are perpetual in nature, for example, stipulating that resources be maintained in perpetuity. Laws may extend those limits to investment returns from those resources and to other enhancements (diminishments) of those resources. Thus, those laws extend donor-imposed restrictions.

Chapter 3 of *Not-for-Profit Entities* emphasizes that the determination of whether net assets are restricted as a result of donor-imposed stipulations (or other restrictions) should be made from the perspective of the NFP reporting entity as a whole and should take into account the existence of separate consolidated entities. Because the consolidated entity may serve a broader purpose than the separate subsidiary, “[a]ll or a portion of a subsidiary’s net assets without donor restrictions might need to be reported as net assets with donor restrictions in the consolidated financial statements.” Conversely, it may also be true, albeit less likely, that “all or a portion of a subsidiary’s net assets with donor restrictions might need to be reported as net assets without donor restrictions in the consolidated financial statements.”

Paragraphs 3.22, 3.113, and 3.114 of *Not-for-Profit Entities* contain the following examples, which demonstrate the concepts discussed above:

**3.22** [A] voluntary health and welfare entity has a broad mission of helping low income families and is the parent of an NFP that has a mission of running a day care and after-school care center for children in the county. The subsidiary NFP received a gift of a small office building subject to the donor’s restriction that it be used for providing day care or after-school care or for the administrative support of those programs. In the separate financial statements of the subsidiary, those assets are not separately reported as restricted assets because the use of the assets is no narrower than the nature of the NFP and the purposes specified in its articles of incorporation and bylaws. However, when the subsidiary NFP is consolidated with its voluntary health and welfare entity parent, the office building would be reported separately with related disclosures because the donor-imposed restriction to use the building for day care, after-school care, or the administrative support of those two programs is narrower than the broad mission of helping low income families of the reporting entity.

**3.113** [A] membership association has a subsidiary foundation that has as its sole mission to provide scholarships. Donors make contributions to the subsidiary with the intent that the subsidiary use the contributions to support its mission without restriction, including granting scholarships and incurring fund-raising and general and administrative expenses. The gifts to the subsidiary are therefore classified as increases in net assets without donor restrictions in the separately issued financial statements of the subsidiary. However, when the subsidiary’s financial statements are consolidated with those of the membership association, the classification of the net assets of the subsidiary would be changed to reflect that they are net assets with donor restrictions from the perspective of the consolidated financial statements. Likewise, investment income on donor-restricted endowment funds of the subsidiary would be reported as net assets with donor restrictions in the consolidated financial statements if they were required to be used for scholarships, even if an appropriation had released the time restriction.

**3.114** [A]n NFP adoption agency has a subsidiary whose mission is to raise funds for various children’s causes, including adoption, foster care, and parental training. If donors restrict their contributions for adoption services, the subsidiary classifies them as increases in net assets with donor restrictions. However, when the subsidiary’s financial statements are consolidated with those of the adoption entity, the classification of the net assets of the subsidiary would be changed to reflect that they are without donor restrictions from the perspective of the reporting entity, which remains primarily an adoption agency.
E.6.5.2 Disclosures for Noncontrolling Interests

ASC 958-810

50-1 If consolidated financial statements are presented, the reporting entity (parent) shall disclose any restrictions made by entities outside of the reporting entity on distributions from the controlled not-for-profit entity (NFP) (subsidiary) to the parent and any resulting unavailability of the net assets of the subsidiary for use by the parent.

50-4 An NFP (parent) that has one or more consolidated subsidiaries with a noncontrolling interest shall provide a schedule of changes in consolidated net assets attributable to the parent and the noncontrolling interest either in notes to the consolidated financial statements or on the face of financial statements, if practicable. That schedule shall reconcile beginning and ending balances of the parent's controlling interest and the noncontrolling interests for each class of net assets for which a noncontrolling interest exists during the reporting period.

50-5 The schedule required by the preceding paragraph shall, at a minimum, include:
   a. A performance indicator, if the entity is a not-for-profit, business-oriented health care entity (see Section 954-10-15)
   b. Amounts of discontinued operations
   c. Subparagraph superseded by Accounting Standards Update No. 2015-01.
   d. Changes in ownership interests in a subsidiary, including investments by and distributions to noncontrolling interests acting in their capacity as owners, which shall be reported separate from any revenues, expenses, gains, or losses and outside any measure of operations, if reported
   e. An aggregate amount of all other changes in net assets without donor restrictions and net assets with donor restrictions for the period.

50-6 Paragraph 958-810-55-25 illustrates the required disclosures using a reconciling schedule in notes to the consolidated financial statements.

An NFP that presents consolidated financial statements and has one or more consolidated subsidiaries with a noncontrolling interest must provide the disclosures discussed above. ASC 958-810-55-17 through 55-25 illustrate how an NFP may present and disclose noncontrolling interests in accordance with ASC 958-810.

E.6.5.3 Disclosures Required When Consolidated Financial Statements Are Not Presented

ASC 958-810

50-2 If, as described in paragraph 958-810-25-4, an NFP (the reporting entity) controls a related but separate NFP through a form other than majority ownership interest, sole corporate membership, or majority voting interest in the board of the other entity and has an economic interest in that other NFP, the reporting entity shall disclose all of the following information if it does not present consolidated financial statements:
   a. Identification of the other NFP and the nature of its relationship with the reporting entity that results in control
   b. Summarized financial data of the other NFP, which shall include the following information:
      1. Total assets, liabilities, net assets, revenue, and expenses
      2. Resources that are held for the benefit of the reporting entity or that are under its control.
   c. The disclosures required by paragraphs 850-10-50-1 through 50-6.
The existence of control or an economic interest, but not both, as described in paragraph 958-810-25-5, requires the disclosures in paragraphs 850-10-50-1 through 50-6. (The existence of an economic interest does not necessarily cause the entities to be related parties. However, the disclosures in those paragraphs are required if an economic interest exists.)

If an NFP holds both (1) an economic interest in another NFP and (2) control through means other than a majority ownership interest, sole corporate membership, or a majority voting interest in the board (see Section E.6.2.2.3), it must disclose the quantitative and qualitative information required by ASC 958-810-50-2 if it does not present consolidated financial statements.

If an NFP holds either an economic interest in another NFP or control of the other NFP, but not both (see Section E.6.2.2.4), it must disclose the information required by ASC 850-10-50-1 through 50-6.

**E.6.5.4 Disclosures Required When an NFP Consolidates a For-Profit Entity**

ASC 958-810 does not provide specific presentation and disclosure requirements for an NFP that has a controlling financial interest in a for-profit entity. Paragraph 3.118 of *Not-for-Profit Entities* states that in determining the relevance of the for-profit subsidiary and the presentation and disclosures that would be most meaningful to financial statement users, an NFP should consider the following factors:

- The size of the for-profit subsidiary in relation to the NFP parent. The larger the for-profit subsidiary is in relation to the NFP, the more likely it is that discrete information about the for-profit subsidiary would be meaningful to financial statement users.

- The activities of the for-profit subsidiary in relation to the mission of the NFP parent. The more marginal the activities of the for-profit subsidiary are to the mission of the NFP, the more likely it is that discrete information about the for-profit subsidiary would be meaningful to financial statement users.

- The need for creditors to have separate information about the for-profit subsidiary, including information about guarantees of the for-profit subsidiary's debt or limitations on transferring cash to or from the subsidiary. If the assets of a for-profit subsidiary are encumbered (for example, by mortgages, contracts, or other matters), it may be meaningful to include discrete information about the for-profit subsidiary's total assets, equity, and changes in equity, similar to the disclosures required to be reported by business entities pursuant to FASB ASC 280.

In addition, paragraphs 3.121 through 3.126 of *Not-for-Profit Entities* provide the following three examples (not all-inclusive) of ways an NFP may present information related to for-profit subsidiaries:

**Example A**

**3.121** NFP Trade Association creates a wholly owned for-profit subsidiary (For-Profit Training Facility) to provide continuing professional education to its members. For-Profit Training Facility incurs debt in order to build a classroom building. The debt is secured solely by a mortgage on For-Profit Training Facility's assets. NFP Trade Association's mission includes providing training to its members. Although members could obtain training from other service providers, the training is integral to NFP Trade Association's overall mission.

**3.122** It may be most meaningful to report For-Profit Training Facility's assets, liabilities, revenues, expenses, and cash flows as part of the overall activities of NFP Trade Association, without discrete information presented on the face of the financial statements about For-Profit Training Facility. However, the notes to the financial statements would include any material disclosures that relate only to the For-Profit Training Facility, such as to disclose any collateral-based debt for which the For-Profit Training Facility is obligated or any assets restricted solely for the use of the Facility.
Example B

3.123 NFP College creates a wholly owned for-profit subsidiary, For-Profit Day Care Center, that operates a day care center for the benefit of its students and faculty. The College does not use the day care center as a teaching resource for its students. For-Profit Day Care Center has no outstanding debt.

3.124 Because the day care center provides services to students, but is peripheral and incidental to the mission of the college, it may be most meaningful to report the assets, liabilities, activities, and cash flows of For-Profit Day Care Center in a manner similar to an auxiliary operation in the college’s financial statements. (Auxiliary operations typically are reported on the statement of activities with one line for total revenues and one line for total expenses; the statement of financial position and statement of cash flows do not separate information associated with auxiliary operations.) Alternatively, it may be meaningful to present the operations of the day care center separately on the statement of activities.

Example C

3.125 NFP Community Organization received a contribution of 100% of the voting common stock of a For-Profit Plastics Company. The terms of the contribution agreement state that For-Profit Plastics Company’s net income may be used for NFP Community Organization’s general operations. NFP Community Organization is not involved in the day-to-day management of For-Profit Plastics Company.

3.126 If For-Profit Plastics Company is material to NFP Community Organization’s financial statements, it may be meaningful to report the assets, liabilities, activities, and cash flows of For-Profit Plastics Company separately from those of NFP Community Organization. Acceptable methods of doing so include, but are not limited to, presenting (a) consolidating financial statements, or (b) consolidated financial statements with note disclosure of the assets, liabilities, net assets, activities, and cash flows of For-Profit Plastics Company.

E.6.6 Health Care Entities

ASC 954-810

05-2 An integrated health care system typically consists of multiple related entities, operating both for-profit entities and not-for-profit entities (NFPs). A not-for-profit parent entity may be the sole corporate member or, through other means, it may control other entities such as a not-for-profit hospital, a not-for-profit medical foundation that contracts with a for-profit physician group, or other not-for-profit providers such as a long-term care center, a substance abuse center, a surgery center, or an outpatient clinic. The system also may own stock in various for-profit ventures such as health maintenance organizations or insurance entities that may or may not provide patient care. Fundraising typically is accomplished through a separate foundation. Foundations, auxiliaries, guilds, and similar entities frequently assist and, in many instances, are related to the health care entity.

05-3 The rights and powers of the controlling entity may vary depending on the legal structure of the controlled entity and the nature of control. The majority owner of a for-profit entity’s voting stock or the sole corporate member of an NFP may not only have the ability to determine the direction of the controlled entity but also have the proportionate right to (or the responsibility for) operating results and a residual interest in the net assets upon dissolution. However, in other situations, the rights of the controlling party may be more limited. For example, in the case of a sole general partner in a limited partnership, the limited partners — and not the general partner — may be entitled to the net assets upon dissolution.

45-1 Whether the financial statements of a reporting health care entity and those of one or more other for-profit entities or not-for-profit entities (NFPs) shall be consolidated, whether those other entities shall be reported using the equity method, and the extent of disclosure that is be required (if any) if consolidated financial statements are not presented, shall be based on the nature of the relationship between the entities. See paragraphs 954-810-15-2 through 15-3.

Applying the consolidation rules to health care entities may be complex because, as described above, an integrated health care system generally consists of several related entities that may be NFPs or for-profit entities. See Sections E.6.6.1 and E.6.6.2 for a discussion of how to determine the correct accounting model to apply.
E.6.6.1 Accounting Model for a Reporting Entity That Is an Investor-Owned Health Care Entity

ASC 954-810

15-2 If the reporting entity is an investor-owned health care entity, this Subtopic provides consolidation guidance for reporting relationships with other entities in addition to the guidance in the following locations:

a. Pursuant to paragraph 810-10-15-3(a), if an investor-owned health care entity has an interest in an entity, it must determine whether that entity is within the scope of the Variable Interest Entities Subsections of Subtopic 810-10 pursuant to paragraph 810-10-15-14. If that entity is within the scope of the Variable Interest Entities Subsections, the investor-owned health care entity shall first apply the guidance in those Subsections. Paragraph 810-10-15-17 provides specific exceptions to applying the Variable Interest Entities Subsections.

b. Pursuant to paragraph 810-10-15-3(b), if the investor-owned health care entity has an interest in an entity that is not within the scope of the Variable Interest Entities Subsections of Subtopic 810-10 and is not within the scope of the Subsections mentioned in paragraph 810-10-15-3(c), it shall use only the guidance in the General Subsections of Subtopic 810-10 to determine whether that interest constitutes a controlling financial interest.

c. Pursuant to paragraph 810-10-15-3(c), if the investor-owned health care entity has a contractual management relationship with another entity (for example, a physician practice) and that other entity is not within the scope of the Variable Interest Entities Subsections of Subtopic 810-10, it shall use the guidance in the Consolidation of Entities Controlled by Contract Subsections of Subtopic 810-10 to determine whether the arrangement constitutes a controlling financial interest.

d. Subparagraph superseded by Accounting Standards Update No. 2015-02.

e. Pursuant to Section 810-30-15, if the investor-owned health care entity is a sponsor in a research and development arrangement, it shall apply the guidance in Subtopic 810-30.

Table E-2 below summarizes the guidance above on determining which accounting model to apply when a reporting entity is an investor-owned health care entity (not an NFP) that has a reporting relationship with another entity.

<table>
<thead>
<tr>
<th>Reporting Relationship</th>
<th>Accounting Model</th>
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</table>
| Interest in an entity that does not qualify for any of the scope exceptions in ASC 810-10-15-17 to application of the VIE model (see Section 3.4) | • Determine whether the entity is a VIE (see Chapter 5).  
• If the entity is a VIE, apply the VIE model to determine the primary beneficiary (see Chapter 7). |
| Interest in an entity that qualifies for one of the scope exceptions in ASC 810-10-15-17 to application of the VIE model (see Section 3.4) | Apply the voting interest entity model (see Appendix D). |
| Contractual management relationship with another entity (e.g., a physician practice) not within the scope of the VIE guidance | Apply the contract-controlled entity model to determine whether the arrangement represents a controlling financial interest (see Section D.3.4).* |
| Sponsor in a research and development arrangement | Apply ASC 810-30 (see Section D.3.3).* |

* In September 2017, the FASB issued for public comment a proposed ASU that would, among other proposed amendments, eliminate the research and development guidance in ASC 810-30 since, according to user outreach, it is not used in practice.
If the reporting entity is a not-for-profit business-oriented health care entity, this Subtopic provides consolidation guidance for reporting relationships with other entities in addition to the guidance in the following locations:

a. Pursuant to paragraph 810-10-15-17, not-for-profit business-oriented health care entities are not subject to the Variable Interest Entities Subsections of Subtopic 810-10 unless the not-for-profit entity is used by a business entity in a manner similar to a VIE in an effort to circumvent the provisions of those Subsections.

b. If the not-for-profit, business-oriented health care entity has an investment in a for-profit entity, it shall use the guidance in the General Subsections of Subtopic 810-10 to determine whether that interest constitutes a controlling financial interest.

c. If the not-for-profit, business-oriented health care entity has a contractual management relationship with another entity (for example, a physician practice), it shall use the guidance in the Consolidation of Entities Controlled by Contract Subsections of Subtopic 810-10 to determine whether the arrangement constitutes a controlling financial interest.

d. Subparagraph superseded by Accounting Standards Update No. 2015-02.

dd. If the not-for-profit, business-oriented health care entity is the general partner or limited partner of a for-profit limited partnership or similar legal entity (such as a limited liability company that has governing provisions that are the functional equivalent of a limited partnership), it shall apply the guidance in paragraphs 958-810-25-11 through 25-29 and 958-810-55-16A through 55-16I.

e. If the not-for-profit, business-oriented health care entity is a sponsor in a research and development arrangement, it shall apply the guidance in Subtopic 810-30.

f. If the not-for-profit, business-oriented health care entity has a relationship with another not-for-profit entity that involves control, an economic interest, or both, it shall apply the guidance in Subtopic 958-810.

g. If the not-for-profit, business-oriented health care entity is engaged in leasing transactions with a special-purpose-entity (SPE) lessor, it shall consider whether it should consolidate the lessor in accordance with the guidance in paragraphs 958-810-25-8 through 25-10.

h. Except where it elects to report such interests at fair value in accordance with the Fair Value Option Subsections of Subtopic 825-10, a not-for-profit, business-oriented health care entity that owns 50 percent or less of the common voting stock of an investee and can exercise significant influence over operating and financial policies shall apply the guidance in Subtopic 323-10.

i. Except where it elects to report such interests at fair value in accordance with the Fair Value Option Subsections of Subtopic 825-10, a not-for-profit, business-oriented health care entity shall report noncontrolling interests in for-profit real estate partnerships, limited liability entities, and similar entities over which the reporting entity has more than a minor interest under the equity method in accordance with the guidance in Subtopic 970-323. A not-for-profit, business-oriented health care entity shall apply the guidance in paragraph 970-323-25-2 to determine whether its interest in a for-profit partnership, limited liability entity, or similar entity is a controlling interest or a noncontrolling interest. A not-for-profit, business-oriented health care entity shall apply the guidance in paragraph 323-30-35-3 to determine whether a limited liability entity should be viewed as similar to a partnership, as opposed to a corporation, for purposes of determining whether a noncontrolling interest in a limited liability entity or a similar entity should be accounted for in accordance with Subtopic 970-323 or Subtopic 323-10.
NFPs are not subject to the VIE guidance (see Section 3.4.1). The following table summarizes how a business-oriented health care NFP reporting entity that has a reporting relationship with another entity can determine which accounting model to apply.

<table>
<thead>
<tr>
<th>Reporting Relationship</th>
<th>Accounting Model</th>
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<tbody>
<tr>
<td>Investment in a for-profit entity</td>
<td>Apply the voting interest entity model (see Appendix D).</td>
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<tr>
<td>Contractual management relationship with another entity (e.g., a physician practice)</td>
<td>Apply the contract-controlled entity model to determine whether the arrangement represents a controlling financial interest (see Section D.3.4).</td>
</tr>
<tr>
<td>Sponsor in a research and development arrangement</td>
<td>Apply ASC 810-30 (see Section D.3.3).</td>
</tr>
<tr>
<td>Relationship with another NFP that involves control, an economic interest, or both</td>
<td>Apply ASC 958-810 (see Section E.6.2).</td>
</tr>
<tr>
<td>Engaged in leasing transactions with an SPE lessor</td>
<td>Apply ASC 958-810-25-8 through 25-10 (see Section E.6.3).</td>
</tr>
<tr>
<td>Ownership of 50 percent or less of the common voting stock of an investee and ability to exercise significant influence over operating and financial policies</td>
<td>Apply ASC 323-10 except when electing to report such interest at fair value in accordance with ASC 825-10 (see Section E.6.4.3).</td>
</tr>
</tbody>
</table>
| Noncontrolling interests in for-profit real estate partnerships, limited liability entities, and similar entities over which the NFP has more than a minor interest | • Apply ASC 970-323-25-2 to determine whether the NFP's interest is a controlling financial interest or a noncontrolling interest.  
  • If the noncontrolling interest is in a partnership or limited liability company that is similar to a partnership on the basis of the guidance in ASC 323-30-35-3, apply ASC 970-323 except when electing to report such interest at fair value in accordance with ASC 825-10.  
  • If the noncontrolling interest is in a limited liability company that is similar to a corporation, apply ASC 323-10 except when electing to report such interest at fair value in accordance with ASC 825-10. |

See Section E.6.4.4.
E.6.6.3  Presentation and Disclosures for a Reporting Health Care Entity

ASC 954-810

Paragraph 958-810-25-2A explains that, in some situations, certain actions require approval by a supermajority vote of the board. That paragraph states that such voting requirements might overcome the presumption of control by the owner or holder of a majority voting interest. (For related implementation guidance, see paragraph 958-810-55-4A.) Pursuant to paragraph 810-10-15-17(a) a not-for-profit, business-oriented health care entity is not subject to the Variable Interest Entities Subsections of Subtopic 810-10, except that it may be a related party for purposes of applying paragraphs 810-10-25-42 through 25-44. Also, if a not-for-profit, business-oriented health care entity is used by business entities in a manner similar to a variable interest entity (VIE) in an effort to circumvent the provisions of the Variable Interest Entities Subsections of Subtopic 810-10, that not-for-profit entity shall be subject to the Variable Interest Entities Subsections of that Subtopic.

A parent corporation typically owns stock in a for-profit entity, whereas a sole corporate member holds membership rights in a not-for-profit entity. Sole corporate membership in a not-for-profit entity, like ownership of a majority voting interest in a for-profit entity, shall be considered a controlling financial interest, unless control does not rest with the sole corporate member (for instance, if the other [membership] entity is in bankruptcy or if other legal or contractual limitations are so severe that control does not rest with the sole corporate member).

When consolidated financial statements are required or permitted by Section 958-810-25, a noncontrolling interest shall be provided if such interest is represented by an economic interest whereby the noncontrolling interest would share in the operating results or residual interest upon dissolution. (See presentation and disclosure requirements in Sections 958-810-45 and 958-810-50, respectively.)

Not-for-profit, business-oriented health care entities shall not report an investment in an entity at fair value, as described in paragraph 958-325-35-6, if that entity is required to be consolidated.

Medical Malpractice Claims

In general, a trust fund, whether legally revocable or irrevocable, shall be included in the financial statements of the health care entity. A portion of the fund equal to the amount of assets expected to be liquidated to pay malpractice claims classified as current liabilities shall be classified as a current asset; the balance of the fund, if any, shall be classified as a noncurrent asset. Revenues and administrative expenses of the trust fund are included in the statement of operations. In some circumstances, the foregoing may not be possible (for example, if a common trust fund exists for a group of health care entities; if the health care entity is part of a common municipality risk-financing internal service fund; or if the legal, regulatory, or indenture restrictions prevent the inclusion of a trust fund in a health care entity’s financial statements).

The existence of the trust fund and whether it is irrevocable shall be disclosed in the financial statements.

Noncontrolling Interests

A not-for-profit, business-oriented health care entity shall include the performance indicator in the schedule required by paragraphs 958-810-50-4 through 50-5. Paragraph 958-810-55-25 illustrates the required disclosure using a reconciling schedule in notes to the consolidated financial statements.

Much of the above guidance on presentation and disclosures for health care entities is consistent with ASC 958-810 (see Section E.6.5).
### F.1 Introduction

<table>
<thead>
<tr>
<th><strong>ASC 810-10</strong></th>
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<tr>
<td><strong>40-3A</strong></td>
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### Pending Content (Transition Guidance: ASC 606-10-65-1)

**40-3A** The deconsolidation and derecognition guidance in this Section applies to the following:

- **a.** A subsidiary that is a nonprofit activity or a business, except for either of the following:
  1. Subparagraph superseded by Accounting Standards Update No. 2017-05
  2. A conveyance of oil and gas mineral rights (for guidance on conveyances of oil and gas mineral rights and related transactions, see Subtopic 932-360)
  3. A transfer of a good or service in a contract with a customer within the scope of Topic 606.
- **b.** A group of assets that is a nonprofit activity or a business, except for either of the following:
  1. Subparagraph superseded by Accounting Standards Update No. 2017-05
  2. A conveyance of oil and gas mineral rights (for guidance on conveyances of oil and gas mineral rights and related transactions, see Subtopic 932-360)
  3. A transfer of a good or service in a contract with a customer within the scope of Topic 606.
- **c.** A subsidiary that is not a nonprofit activity or a business if the substance of the transaction is not addressed directly by guidance in other Topics that include, but are not limited to, all of the following:
  1. Topic 606 on revenue from contracts with customers
  2. Topic 845 on exchanges of nonmonetary assets
  3. Topic 860 on transferring and servicing financial assets
  4. Topic 932 on conveyances of mineral rights and related transactions
  5. Subtopic 610-20 on gains and losses from the derecognition of nonfinancial assets.

**40-3B** The deconsolidation and derecognition guidance in this Section does not apply to a parent that ceases to have a controlling financial interest (as described in this Subtopic) in a subsidiary that is in substance real estate as a result of default on the subsidiary's nonrecourse debt. For guidance in these circumstances, see Subtopic 360-20, including the related implementation guidance in paragraphs 360-20-55-68 through 55-77.

**40-4** A parent shall deconsolidate a subsidiary or derecognize a group of assets specified in paragraph 810-10-40-3A as of the date the parent ceases to have a controlling financial interest in that subsidiary or group of assets. See paragraph 810-10-55-4A for related implementation guidance.

**40-4A** When a parent deconsolidates a subsidiary or derecognizes a group of assets within the scope of paragraph 810-10-40-3A, the parent relationship ceases to exist. The parent no longer controls the subsidiary’s assets and liabilities or the group of assets. The parent therefore shall derecognize the assets, liabilities, and equity components related to that subsidiary or group of assets. The equity components will include any noncontrolling interest as well as amounts previously recognized in accumulated other comprehensive income. If the subsidiary or group of assets being deconsolidated or derecognized is a foreign entity (or represents the complete or substantially complete liquidation of the foreign entity in which it resides), then the amount of accumulated other comprehensive income that is reclassified and included in the calculation of gain or loss shall include any foreign currency translation adjustment related to that foreign entity. For guidance on derecognizing foreign currency translation adjustments recorded in accumulated other comprehensive income, see Section 830-30-40.
40-5 If a parent deconsolidates a subsidiary or derecognizes a group of assets through a nonreciprocal transfer to owners, such as a spinoff, the accounting guidance in Subtopic 845-10 applies. Otherwise, a parent shall account for the deconsolidation of a subsidiary or derecognition of a group of assets specified in paragraph 810-10-40-3A by recognizing a gain or loss in net income attributable to the parent, measured as the difference between:

a. The aggregate of all of the following:
   1. The fair value of any consideration received
   2. The fair value of any retained noncontrolling investment in the former subsidiary or group of assets at the date the subsidiary is deconsolidated or the group of assets is derecognized
   3. The carrying amount of any noncontrolling interest in the former subsidiary (including any accumulated other comprehensive income attributable to the noncontrolling interest) at the date the subsidiary is deconsolidated.

b. The carrying amount of the former subsidiary's assets and liabilities or the carrying amount of the group of assets.

40-6 A parent may cease to have a controlling financial interest in a subsidiary through two or more arrangements (transactions). Circumstances sometimes indicate that the multiple arrangements should be accounted for as a single transaction. In determining whether to account for the arrangements as a single transaction, a parent shall consider all of the terms and conditions of the arrangements and their economic effects. Any of the following may indicate that the parent should account for the multiple arrangements as a single transaction:

a. They are entered into at the same time or in contemplation of one another.

b. They form a single transaction designed to achieve an overall commercial effect.

c. The occurrence of one arrangement is dependent on the occurrence of at least one other arrangement.

d. One arrangement considered on its own is not economically justified, but they are economically justified when considered together. An example is when one disposal is priced below market, compensated for by a subsequent disposal priced above market.

Under ASC 810-10-40-4, a parent should generally deconsolidate a subsidiary or derecognize a group of assets as of the date the parent ceases to have a controlling financial interest in that subsidiary or group of assets. Upon loss of control, the parent should derecognize the assets, liabilities, and equity components related to the subsidiary or group of assets. However, as discussed in Section F.2, there are certain exceptions to applying the ASC 810 deconsolidation and derecognition principles.

ASC 810-10-55-4A provides the following four examples of events that would result in a change that causes a parent to deconsolidate its subsidiary:

1. “A parent sells all or part of its ownership interest in its subsidiary and, as a result, the parent no longer has a controlling financial interest in the subsidiary.”

2. “The expiration of a contractual agreement that gave control of the subsidiary to the parent.”

3. “The subsidiary issues shares, which reduces the parent's ownership interest in the subsidiary so that the parent no longer has a controlling financial interest in the subsidiary.”

4. “The subsidiary becomes subject to the control of a government, court, administrator, or regulator.”
Since the above examples do not represent all situations that could trigger loss of control, a reporting entity must consider all relevant facts and circumstances. A change in the determination of whether the reporting entity holds a controlling financial interest in a legal entity could occur as a result of many other events besides those indicated in the examples above.

F.2 Scope of Deconsolidation of a Subsidiary or Derecognition of a Group of Assets

ASC 810-10-40-3A provides separate guidance on the scope for application of the deconsolidation and derecognition guidance in ASC 810-10-40-5 on the loss of control of (1) a nonprofit activity or business and (2) a subsidiary that is not a nonprofit activity or business.

For a reporting entity to lose control of a business (see ASC 805-10-55-3A for the definition of a business, and see Deloitte’s A Roadmap to Accounting for Business Combinations for further discussion of the topic), there does not need to be a separate subsidiary established (i.e., a group of assets representing a business can be derecognized from a larger legal entity). ASC 810’s deconsolidation and derecognition guidance does not apply to a sale of in-substance real estate or to a conveyance of oil and gas mineral rights, even if the loss of control was related to assets that otherwise would meet the definition of a business.

The deconsolidation and derecognition guidance in ASC 810-10-40-5 also applies to subsidiaries that are not a nonprofit activity or business unless the substance of the transaction is addressed by other GAAP, which would include but not be limited to the following:

- Revenue transactions (ASC 606). See Section F.2.2.
- Exchanges of nonmonetary assets (ASC 845). See Section F.2.4.
- Transfers of financial assets (ASC 860). See Section F.2.3.
- Conveyances of mineral rights and related transactions (ASC 932).
- Sales of in-substance real estate (ASC 360 or ASC 976). See Section F.2.1.
- Gains and losses from derecognition of nonfinancial assets (ASC 610-20). See Section F.2.1.2.

In essence, ASC 810-10-40-3A provides that a reporting entity should not ignore other GAAP that would otherwise have been applicable simply because, for example, the reporting entity transferred an equity interest in a subsidiary to effect the transaction.

Note that ASC 360-20, which provides guidance on real estate sale transactions, was partially superseded by ASC 606 and ASC 610-20 upon the adoption of the new revenue standard. However, ASC 360-20 continues to apply to sale-and-leaseback transactions involving real estate assets until the amendments in ASU 2016-02 on leases take effect. See Chapter 17 of Deloitte’s A Roadmap to Applying the New Revenue Recognition Standard for further discussion of nonfinancial assets.

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1 ASU 2019-10 delayed the effective date of ASU 2016-02 for all nonpublic companies. ASU 2020-05 further delayed the effective date for all nonpublic companies as well as for certain public NFPs. As a result, ASU 2016-02 is effective for nonpublic companies in annual periods beginning after December 15, 2021, and interim periods within fiscal years beginning after December 15, 2022. For public NFPs that qualify for the deferral under ASC 842-10-65-1(a), ASU 2016-02 is effective for annual periods beginning after December 15, 2019, and interim periods therein. The effective date for all other public companies remains unchanged. The delayed effective date for nonpublic companies also applies to all other ASUs associated with ASU 2016-02.
F.2.1 Deconsolidation or Derecognition of In-Substance Real Estate

The paragraphs below and in Section F.2.1.1 discuss the guidance in ASC 360-20 on in-substance real estate transactions. ASC 360-20 was partially superseded by the new revenue standard (ASC 606) and ASC 610-20; see Section F.2.1.2. However, if a sale of in-substance real estate is part of a sale-and-leaseback transaction, an entity would evaluate the transaction under ASC 840-40 until it adopts the new leases guidance (ASC 842). After adopting that guidance, an entity would evaluate a sale-and-leaseback transaction under ASC 842-40, which does not carry forward the linkage to the guidance in ASC 360-20. For entities that have adopted ASC 606 and ASC 610-20, ASC 360-20 continues to apply to sale-and-leaseback transactions involving real estate assets until the adoption of ASC 842. The guidance below does not apply to entities that have adopted the new revenue and leases guidance.

The deconsolidation of a subsidiary, or derecognition of a group of assets, that is considered in-substance real estate is excluded from the deconsolidation procedures described in ASC 810-10-40. See Section F.2.1.1 for a discussion of the determination of whether a legal entity or group of assets represents in-substance real estate. Common examples of transactions excluded from ASC 810-10-40 include sales of stock of legal entities with substantial real estate, sales of partnership interests with substantial real estate, and sales of time-sharing interests. Further, any sale of a financial asset that is in-substance real estate is not within the scope of ASC 810-10-40. Accordingly, a reporting entity should apply the guidance on the sale of real estate in ASC 360-20 or ASC 976-605\textsuperscript{2} to account for such dispositions. This is the case regardless of whether the in-substance real estate meets the definition of a business. The requirements for derecognition in ASC 360-20 are different from those in ASC 810 and may result in different accounting treatment.

Note, however, that the determination of whether a reporting entity has a controlling financial interest (and should consolidate a legal entity that is in-substance real estate) is still required. That is, to achieve derecognition of in-substance real estate, the legal entity must not be consolidated under ASC 810-10 and must satisfy the derecognition criteria in ASC 360-20. These determinations do not necessarily need to be made in any order; however, the conditions in both ASC 360-20 and ASC 810-10 must be met for a reporting entity to derecognize in-substance real estate. The scope exception in ASC 810-10-40-5 for in-substance real estate only addresses the mechanics of accounting for the derecognition transaction, not whether deconsolidation/derecognition has been achieved.

The loss of a controlling financial interest that is in-substance real estate could occur as a result of many events, including the sale or transfer of ownership interests held by a reporting entity in a legal entity, the issuance of additional ownership interests, foreclosure, or a change in a contractual arrangement. Since the sale of in-substance real estate is specifically excluded from the deconsolidation guidance in ASC 810-10-40, questions have arisen regarding whether all losses of a controlling financial interest in a legal entity that is in-substance real estate are outside the scope of ASC 810-10-40’s deconsolidation guidance or whether ASC 360-20 is limited to transactions that are economic sales of the interests held in in-substance real estate.

\textsuperscript{2} ASC 976-605 provides guidance on sales of retail land. For the remainder of this appendix, for ease of reading, the guidance on real estate is referred to only as ASC 360-20.
EITF 10-E discussed this situation without resolution. In paragraph 4 of Issue 10-E, the matter was framed as follows:

This Issue seeks to resolve the differing views in practice about whether the guidance in Subtopic 360-20 applies to transactions or events, including foreclosure, that result in deconsolidation of in-substance real estate. Examples of events that would result in deconsolidation of in-substance real estate entities include but are not limited to:

a. The entity defaults on its debt obligations resulting in a change in the entity’s primary beneficiary without a transfer of the entity’s equity interests or its assets or the extinguishment of its debt. This may occur, for example, when the lender has rights that are exercisable only in the event of default by the entity, but that once exercisable give the lender the power to direct the activities that most significantly impact the entity’s economic performance.

b. The entity defaults on nonrecourse debt and the lender becomes the primary beneficiary of the entity. The lender subsequently loses control of the entity upon an extinguishment or modification of the debt with the entity.

c. The governance provisions of the entity are changed, triggering a change in control of the entity.

Because a consensus was not reached on Issue 10-E, there may be diversity in practice. Some believe that any loss of a controlling financial interest in a subsidiary that is in-substance real estate should be excluded from the scope of ASC 810-10-40 and therefore should be within the scope of ASC 360-20-40. We believe that this is an acceptable accounting policy choice.

At a minimum, we believe that any deconsolidation that results from default on the subsidiary’s nonrecourse debt, sale, transfer, or issuance of additional ownership interests would be within the scope of ASC 360-20-40. In addition, we generally believe that it would be inappropriate to not consider ASC 360-20-40 for real estate previously transferred to a consolidated subsidiary. That is, since the ASC 360-20-40 derecognition criteria may have not been applied (because of consolidating the transferee), a subsequent deconsolidation of the subsidiary should generally not result in more favorable accounting treatment than would have occurred if the ASC 360-20-40 derecognition criteria had been applied to the original transfer.

However, in the absence of future standard setting, another policy election may be acceptable in limited circumstances, such as when the deconsolidation (1) results from an event other than a default on the subsidiary’s nonrecourse debt, sale, transfer, or issuance of additional ownership interests and (2) the reporting entity did not previously transfer real estate to the legal entity. In such instances, the deconsolidation may be accounted for under ASC 810-10-40. For example, assume that a reporting entity and a third party form a legal entity with cash, the legal entity then acquires real estate, and the reporting entity consolidates the legal entity. Subsequently, if an event occurs (planned or unplanned), other than a sale or transfer, that causes the third-party investor to share power over the legal entity, it may be appropriate to apply ASC 810-10-40 because a real estate “sale” was not involved in the loss of control. If a reporting entity believes that application of the ASC 810-10-40 deconsolidation guidance is appropriate when in-substance real estate is involved, the reporting entity is strongly encouraged to consult with independent accountants.

**F.2.1.1 In-Substance Real Estate**

ASC 360-20-15-2 states the following regarding in-substance real estate:

Determining whether a transaction is in substance the sale of real estate requires judgment. However, in making that determination, one shall consider the nature of the entire real estate component being sold (that is, the land plus the property improvements and integral equipment), and not the land only, in relation to the entire sale-leaseback transaction. Further, that determination shall not consider whether the operations in which the assets are involved are traditional or nontraditional real estate activities. For example, if a ski resort is sold and the lodge and ski lifts are considered to be affixed to the land (that is, they cannot be removed and

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used separately without incurring significant cost), then it would appear that the sale is in substance the sale of real estate and that the entire sale transaction would be subject to the provisions of this Subtopic. Transactions involving the sale of underlying land (or the sale of the property improvements or integral equipment subject to a lease of the underlying land) shall not be bifurcated into a real estate component (the sale of the underlying land) and a non-real-estate component (the sale of the lodge and lifts) for purposes of determining profit recognition on the transaction.

In addition, ASC 976-10-15-4(c) states the following regarding sales that may be considered in-substance real estate:

Sales of corporate stock of entities with substantial real estate, sales of partnership interests, and sales of time-sharing interests if the sales are in substance sales of real estate. An example of a sale of a partnership interest that is in substance a sale of real estate would be an entity forming a partnership, arranging for the partnership to acquire the property directly from third parties, and selling an interest in the partnership to investors who then become limited partners.

However, ASC 976-10 does not define the phrase “substantial real estate.” While there is no bright line in the determination of what percentage of a legal entity’s assets must represent real estate for the entire legal entity to be considered in-substance real estate, we believe that if, on a fair value basis, greater than 90 percent of a legal entity’s assets were determined to be real estate (which includes land, buildings, and other integral equipment), there would be a rebuttable presumption that the legal entity as a whole should be considered in-substance real estate. Similarly, as the percentage of real estate assets to total assets declines below 90 percent, it will become less likely that the legal entity is in-substance real estate.

A reporting entity should use significant judgment and consider all relevant facts and circumstances (both quantitative and qualitative) when determining whether the subsidiary or group of assets is in-substance real estate. The reporting entity should carefully assess what to include in and exclude from the quantitative determination of whether 90 percent of a legal entity’s assets are real estate. For example, in determining the numerator (the fair value of real estate) and the denominator (the total fair value of the legal entity’s assets), the following guidelines, among others, may be appropriate:

- The fair value of the real estate (land, buildings, and integral equipment) should be included in the numerator and denominator.
- Furniture, fixtures, and equipment can be excluded from the numerator but included in the denominator, if the assets are both separable and movable from the real estate (i.e., do not represent integral equipment).
- Cash should be excluded from the numerator and generally from the denominator. Without this treatment, cash could be injected into a legal entity before a derecognition transaction to avoid the real estate rules. All facts and circumstances must be considered. For example, it may be appropriate to include cash if it is the result of a temporary cash position from the disposal of a non-real estate asset with the intention to reinvest in a non-real estate asset.
- Other working capital balances should be excluded from the numerator to the extent that the amounts can be separated from the real estate assets.
- Intangible assets (e.g., existing contractual assets, trademarks, brand names) should be excluded from the numerator to the extent that, legally and practicably, they are able to be separated from the real estate assets.

From a qualitative perspective, the purpose and nature of the legal entity, for example, as an integrated business, as opposed to a real-estate special-purpose entity, may further support the quantitative measures above in the determination of whether a transaction is a sale of in-substance real estate.
Example F-1

Entity X’s only assets are a power plant and a long-term PPA for 100 percent of the power plant’s output. The power plant is the primary source of generation of income for X, the PPA is specifically associated with the power plant, and the PPA cannot be transferred by X. Assume that Company A previously owned 100 percent of the equity interest in X and subsequently transfers 80 percent of the equity interests to Company B. Upon transfer, A determines that it should deconsolidate X.

In this example, since the value of the PPA is inseparable from the real estate (i.e., the power plant), the PPA should be included in the numerator in the quantitative determination of whether 90 percent of X’s assets are in-substance real estate. If the transfer is deemed to be in-substance real estate, A must determine whether it can derecognize the real estate under ASC 360-20 and, if so, apply the derecognition guidance in ASC 360 (as opposed to ASC 810-10-40).

Example F-2

Entity Z is a gaming company that owns casino properties and provides casino entertainment services, including online gambling services. The assets of Z are primarily composed of the casino properties and intangible assets, including Z’s brand name. The brand name is used by Z for online gaming, licensing, and marketing arrangements. Assume that Company Y previously owned 100 percent of Z and subsequently transfers 80 percent of the equity interests to Company X. Upon transfer, Y determines that it should deconsolidate Z.

In this example, the brand name may be bifurcated and separated from the casino properties, both legally and practicably. Since Z can use the brand name in other ways not inextricably linked to the specified casino properties, the value of the brand name may be excluded from the numerator in the quantitative determination of whether 90 percent of Z’s assets are in-substance real estate.

F.2.1.2 Nonfinancial Assets

Upon the adoption of ASU 2014-09, ASC 606 and ASC 610-20 partially supersede ASC 360-20. ASC 610-20 applies to all nonfinancial assets, not only to those within the scope of ASC 350 and ASC 360, if there is no other applicable guidance. ASC 610-20 does not amend or supersede guidance that addresses how to determine the gain or loss on the derecognition of a subsidiary or group of assets that meets the definition of a business. Gains or losses associated with these transactions will continue to be determined in accordance with ASC 810-10-40.

In response to stakeholder feedback indicating that (1) the meaning of the term “in-substance nonfinancial asset” is unclear because the new revenue standard does not define it and (2) the scope of the guidance on nonfinancial assets is confusing and complex and does not specify how a partial sales transaction should be accounted for or which model entities should apply, the FASB issued ASU 2017-05, which clarifies the scope of ASC 610-20 as well as the accounting for partial sales of nonfinancial assets. The newly established guidance in ASC 610-20 (which consists of guidance in ASU 2014-09, as amended by ASU 2017-05) conforms the derecognition guidance on nonfinancial assets with the model for transactions in the new revenue standard (ASC 606, as amended).

The flowchart below outlines considerations related to the application of ASC 606, ASC 810-10, ASC 860, ASC 610-20, or other U.S. GAAP to the transfer of a nonfinancial asset.
Appendix F — Deconsolidation/Derecognition

Start

Is the counterparty a customer? (ASC 606-20-15-4(a))

Yes

Apply ASC 606.

No

Is the transaction the transfer of a business or nonprofit activity? (ASC 610-20-15-4(b))

Yes

Apply ASC 810-10.

No

Is the transaction entirely accounted for in accordance with ASC 860? (ASC 610-20-15-4(e))

Yes

Apply ASC 860.

No

Does another scope exception apply? (ASC 610-20-15-4)

Yes

Apply other ASC topics or subtopics.

No

Are the assets promised in the contract all or substantially all (1) nonfinancial assets or (2) nonfinancial assets and in-substance nonfinancial assets? (ASC 610-20-15-5)

Yes

Apply ASC 610-20 to each distinct nonfinancial asset promised in the contract. Apply other ASC topics or subtopics to the remaining parts of the contract, if any.*

No

Does the contract include the transfer of an ownership interest in one or more consolidated subsidiaries that is not a business? (ASC 610-20-15-6)

Yes

If the assets in an individual consolidated subsidiary are all nonfinancial assets or all nonfinancial and in-substance nonfinancial assets, apply ASC 610-20 to each distinct asset within that subsidiary. Otherwise, apply ASC 810-10-40-3A(c) or ASC 810-10-45-21A(b)(2) to the subsidiary. Apply other ASC topics or subtopics to the remaining parts of the contract, if any.*

No

Apply ASC 610-20 to each distinct nonfinancial asset promised in the contract. Apply other ASC topics or subtopics to the remaining parts of the contract, if any.*

* If the transfer includes other contractual arrangements that are not assets of the seller to be derecognized (e.g., guarantees), those contracts are separated and accounted for in accordance with other ASC topics or subtopics.
See Chapter 17 of Deloitte’s *A Roadmap to Applying the New Revenue Recognition Standard* for additional details regarding sales of nonfinancial assets within the scope of ASC 610-20.

**F.2.2 Revenue Transactions**

In certain situations, the loss of control of a subsidiary that does not represent a business may be, in substance, a revenue transaction. For example, assume that a consolidated subsidiary has service contracts that earn a stream of revenue and the reporting entity sells an interest in the revenue from those contracts to a third party. Even if the reporting entity determines that it no longer has a controlling financial interest in the subsidiary, depending on the facts and circumstances, it may conclude that the transaction is, in substance, a revenue transaction within the scope of ASC 606.

**F.2.3 Deconsolidation of In-Substance Financial Assets**

Financial assets include “common” financial assets, such as loans, mortgages, credit card balances, and receivables, as well as marketable and nonmarketable debt securities, stock purchase warrants, common and preferred stock investments, and other equity investments such as general or limited partnership interests. A reporting entity should apply ASC 860 in lieu of ASC 810 when it has an investment in another consolidated legal entity whose only assets are financial assets. See Section 11.1.2 for additional presentation considerations related to beneficial interests in a CFE.

A reporting entity must analyze the economic characteristics and risks of the legal form of equity being transferred or sold when derecognizing a legal entity whose only assets are financial assets. Specifically, the reporting entity should focus on whether collateral/creditor rights exist in the equity securities, among other considerations, to determine whether the underlying transaction is, in substance, an asset-backed financing arrangement for which ASC 860 should be applied. This view is consistent with the views of an SEC staff member, Professional Accounting Fellow Armando Pimentel, who stated the following at the 1997 AICPA Conference on Current SEC Developments (the “1997 SEC staff speech”):

> The FASB has indicated that a parent company’s investment in its consolidated subsidiary is not a financial asset, and the Staff agrees with this position because any sale of the equity securities of the subsidiary represents the sale of an interest in subsidiary’s individual assets and liabilities, which are not necessarily financial assets under the definition in SFAS 125.

> The Staff recently responded to an inquiry from a registrant regarding the proper accounting guidance to follow in recording a sale of all of the equity securities of a consolidated subsidiary whose only asset was a cost-method investment, which is considered a financial asset under SFAS 125. The Staff concluded that the provisions of SFAS 125 should apply when an entity sells the equity securities of its consolidated subsidiary if all of the assets in the consolidated subsidiary are financial assets.

> This conclusion arose from the Staff’s concern that, otherwise, a company whose transfer of assets would not qualify as a sale under SFAS 125 criteria could sidestep those requirements by simply first transferring the assets to a newly created wholly owned subsidiary and selling the equity securities of that subsidiary. The company might then assert that SFAS 125 did not apply, because the transaction involved the sale of equity securities of the subsidiary, and account for the transfer as a sale under other GAAP that addresses the sale of assets and liabilities.
Similar views were also expressed by Brian Fields at the 2009 AICPA Conference on Current SEC and PCAOB Developments (“2009 SEC staff speech”). Mr. Fields noted that an entity whose transfer of financial assets would not qualify as a sale under the guidance in ASC 860 might attempt to structure a transaction in a manner that sidesteps the criteria for sale accounting. In such a structure, the entity would first transfer the financial assets to a newly created subsidiary (e.g., special-purpose entity) in exchange for all senior and subordinated interests in the subsidiary. All interests are in legal-form equity and do not contain a maturity date. The entity then sells the senior interests to outside investors. The activities of the subsidiary are significantly limited and do not have the breadth and scope of activities of a business. Because it may seem that the sale of the senior interests represented an equity transaction involving owners, the entity might assert that the guidance in ASC 860 does not apply and account for the sale of the senior interests as the issuance of a noncontrolling equity interest rather than as collateralized debt. Mr. Fields cautioned that “when a subsidiary is created simply to issue beneficial interests backed by financial assets rather than to engage in substantive business activities,” the sales of beneficial interests in the subsidiary “should be viewed as transfers of interests in the financial assets themselves” and ASC 860 would apply.

While the 1997 and 2009 SEC staff speeches focused primarily on attempts to structure transactions in a manner that sidesteps the criteria for sale accounting in ASC 860, we believe that the principles in the two speeches apply more broadly because they are examples of an overarching principle in ASC 860. That is, on the basis of consultations involving discussions with the SEC staff, we believe that these principles apply broadly to legal entities that hold only financial items. We do not believe that the accounting model should change by virtue of a clearly inconsequential amount of nonfinancial assets in the entity.

**F.2.3.1 Deconsolidation of Assets Previously Transferred**

If a reporting entity transfers assets to a consolidated legal entity that is subsequently deconsolidated, the reporting entity must apply the requirements in ASC 860 to the assets that were initially transferred to determine whether it is able to derecognize the previously transferred assets.

**F.2.3.2 Electing the Fair Value Option on a Retained Interest Upon Deconsolidation**

When a legal entity is deconsolidated, the reporting entity may elect the fair value option for its retained interest in the newly deconsolidated legal entity. While the fair value option can be elected on an item-by-item basis (e.g., for the residual but not the senior interests held in a collateralized loan obligation entity), the election must be made when each investment is first recognized, and it is irrevocable once made.

**F.2.4 Nonreciprocal Transfer to Owners**

ASC 810-10-40-5 states that if a parent loses control of a subsidiary through a nonreciprocal transfer to owners, such as a spin-off, the guidance in ASC 810-10 on measuring the gain or loss will not apply to the transferred portion. Rather, the transferred portion should be accounted for under ASC 845-10. Therefore, a reporting entity should not evaluate nonreciprocal transfers to owners under ASC 810-10.
F.2.5 Multiple Arrangements Accounted for as a Single Disposal Transaction

In some instances, a parent may cease to have a controlling financial interest in a subsidiary through two or more transactions. The gain or loss recognition by the parent would differ depending on whether the parent accounts for the two or more transactions as multiple transactions separately or as a single transaction. Consider the following:

**Example F-3**

Entity A intends to sell its wholly owned subsidiary, Subsidiary B, for a loss. The current carrying value of B is $100. Entity A structures the sale into two arrangements. In the first arrangement, A sells a 49 percent interest for $40 on July 1, 20X9. In the second arrangement, A sells the remaining 51 percent interest for $41 on September 1, 20X9.

The table below illustrates the total loss that A would record in its consolidated statement of income depending on whether it accounts for the multiple arrangements separately or as a single transaction.

<table>
<thead>
<tr>
<th>Disposable Arrangements Are Accounted for:</th>
<th>Separately</th>
<th>As a Single Transaction</th>
</tr>
</thead>
<tbody>
<tr>
<td>Arrangement 1</td>
<td>$ —*</td>
<td>$ 9</td>
</tr>
<tr>
<td>Arrangement 2</td>
<td>10</td>
<td>10</td>
</tr>
<tr>
<td>Total loss recognized by A</td>
<td>$ 10</td>
<td>$ 19 **</td>
</tr>
</tbody>
</table>

* Because the first arrangement did not cause A to lose its control over B, A would account for it as an equity transaction with no gain or loss recorded in earnings.

** Because both arrangements are accounted for as a single transaction, A would follow the deconsolidation guidance in ASC 810-10-40-5 and record the entire loss in earnings.

To address the different results that may occur, as illustrated above, and the potential for structuring, ASC 810-10-40-6 provides guidance on a parent’s cessation of a controlling financial interest in a subsidiary through two or more arrangements (transactions).

The indicators in ASC 810-10-40-6 are intended to prevent abuse by entities attempting to minimize earnings implications by using multiple arrangements to dispose of a subsidiary. However, in Statement 160 (codified in ASC 810), the FASB observed in paragraph B57 of the Basis for Conclusions that the opportunity for entities to conceal losses through such structuring is reduced by the impairment guidance in Statement 142 (codified in ASC 350) and Statement 144 (codified in ASC 360). Under this guidance, a more-likely-than-not expectation to sell or dispose of a reporting unit (or a significant portion of one) or a long-lived asset (asset group) would trigger an entity’s requirement to perform impairment testing for goodwill and other intangible assets (under ASC 350) and long-lived tangible assets (under ASC 360).

Regardless, when assessing the guidance in ASC 810-10-40-6, reporting entities should ensure that they analyze all terms and conditions of multiple arrangements, including their combined economic effect and intent, to determine whether such arrangements should be accounted for separately or as a single transaction.
F.3  Parent’s Accounting Upon a Loss of Control Over a Subsidiary or Group of Assets

ASC 810-10-40-5 provides a formula for calculating the parent’s gain or loss on deconsolidation, which includes a remeasurement to fair value of the parent’s retained noncontrolling interest in the former subsidiary, if any. The parent’s relationship with the former subsidiary after the transaction, as described below, determines the applicable accounting.

F.3.1  Parent Retains Significant Influence Through Noncontrolling Interest

If the parent ceases to have a controlling financial interest in a subsidiary but still retains an investment that will be accounted for under the equity method in accordance with ASC 323-10, the parent should deconsolidate the subsidiary and recognize a gain or loss in accordance with ASC 810-10-40-5 (see computation in Example F-5). As of the date the loss of control occurs, the former parent remeasures, at fair value, its retained investment and includes any resulting adjustments as part of the gain or loss recognized on deconsolidation.

The parent must apply the equity method of accounting prospectively from the date control over the subsidiary is relinquished and should not revise its presentation of prior-period balances. Similarly, application of the equity method of accounting as if the loss of control occurred at the beginning of the current fiscal period or year is prohibited. This position was reiterated by an SEC staff member, Associate Chief Accountant Stephanie Hunsaker, in a speech at the 2007 AICPA Conference on Current SEC and PCAOB Developments. The remaining investment after the deconsolidation should be reflected in the balance sheet at the end of the period as a single line item.

The parent should perform an assessment under ASC 205-20 to determine whether the deconsolidated subsidiary qualifies as a discontinued operation (see Deloitte’s A Roadmap to Disposals of Long-Lived Assets and Discontinued Operations for additional details related to this assessment). If the deconsolidated subsidiary qualifies as a discontinued operation, the parent should present the gain or loss on deconsolidation in income from discontinued operations. If the deconsolidated subsidiary does not qualify for discontinued operations treatment, the parent should present the gain or loss on deconsolidation in income from continuing operations, typically as nonoperating income.

Example F-4

Investor A is a calendar-year-end company and is the general partner of a limited partnership, Entity B. Entity C, unrelated to A, is the limited partner of B and does not have substantive kick-out rights or substantive participating rights. In accordance with the VIE model, A has historically consolidated B.

On August 1, 20X7, A granted substantive kick-out rights and substantive participating rights to C. Therefore, A is no longer deemed to have control of B and will use the equity method to account for its investment in B. Effective August 1, 20X7, A is required to prospectively apply the equity method of accounting for its investment in B. Note that A’s results of operations and cash flows for the seven-month period ended July 31, 20X7, will continue to present B as a consolidated subsidiary.
F.3.2 Parent Retains Noncontrolling Interest but Does Not Have Significant Influence

If the parent retains an investment in, but is unable to exercise significant influence over, a former subsidiary after it ceases to have a controlling financial interest in that subsidiary, the parent should deconsolidate the subsidiary and recognize a gain or loss in accordance with ASC 810-10-40-5. As of the date the loss of control occurs, the former parent remeasures, at fair value, its retained investment and includes any resulting adjustments as part of the gain or loss recognized on deconsolidation.

The parent must account for its retained interest prospectively as an investment, including presentation as a single line item in the balance sheet, from the date control over the subsidiary is relinquished.

Example F-5

Parent owns 80 percent of its subsidiary that has a book value of $100. Assume that (1) the carrying amounts of the controlling interest (Parent) and noncontrolling interest are $80 and $20, respectively; (2) Parent reduces its interest in the former subsidiary to 10 percent by selling stock for $105; and (3) the fair value of 100 percent of the subsidiary is $150 and the fair value of 10 percent is $15.

The gain on the sale would be computed as follows (ignoring income taxes):

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Fair value of consideration received (cash proceeds)</td>
<td>$105</td>
</tr>
<tr>
<td>Fair value of retained noncontrolling interest in the subsidiary</td>
<td>15</td>
</tr>
<tr>
<td>Carrying value of noncontrolling interest</td>
<td>20</td>
</tr>
<tr>
<td></td>
<td>140</td>
</tr>
<tr>
<td>Less: subsidiary’s book value</td>
<td>100</td>
</tr>
<tr>
<td>Gain on sale</td>
<td>$40</td>
</tr>
</tbody>
</table>

The journal entry would be:

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash</td>
<td>105</td>
</tr>
<tr>
<td>Investment in former subsidiary</td>
<td>15</td>
</tr>
<tr>
<td>Noncontrolling interest in former subsidiary</td>
<td>20</td>
</tr>
<tr>
<td>Net assets of former subsidiary</td>
<td>100</td>
</tr>
<tr>
<td>Gain on sale</td>
<td>40</td>
</tr>
</tbody>
</table>

In addition to disclosing other information required by ASC 810-10-50-1B, Parent must disclose the portion of the $40 gain related to the remeasurement of its retained 10 percent interest to fair value.

F.3.3 Parent Does Not Retain a Noncontrolling Interest

If the parent ceases to have a controlling financial interest in a subsidiary and does not retain an investment in that subsidiary, the parent should deconsolidate the subsidiary and recognize a gain or loss in accordance with ASC 810-10-40-5.
F.3.4  Seller’s (Parent’s) Accounting for Contingent Consideration Upon Deconsolidation of a Subsidiary or Derecognition of a Group of Assets That Is a Business

Under a typical contingent consideration arrangement, a buyer is obligated to transfer additional consideration to a seller as part of the exchange for control of the acquiree if a specified future event occurs or a condition is met. Reporting entities must evaluate the nature of each arrangement to determine whether contingent future payments are (1) part of the exchange for control (i.e., contingent consideration) or (2) a separate transaction. Examples of contingent payment arrangements that are separate transactions include, but are not limited to, payments related to compensation for services, consulting contracts, profit-sharing agreements, property lease agreements, and executory contracts. This discussion does not address contingent payment arrangements that are separate transactions. That is, it only discusses arrangements in which the payment is contingent consideration. Further, it is assumed in this discussion that the seller has determined that the arrangement does not meet the definition of a derivative instrument. If the arrangement met the definition of a derivative, it would be accounted for under ASC 815.

Accounting for contingent consideration was discussed in EITF 09-4. At its September 9–10, 2009, meeting, the EITF considered two approaches for a seller’s accounting for a contingent consideration arrangement upon deconsolidation of a subsidiary or derecognition of a group of assets that meets the definition of a business; however, the Task Force did not reach a consensus on this issue. Accordingly, there has been diversity in practice related to a seller’s accounting for a contingent consideration arrangement. Nevertheless, reporting entities should establish an accounting policy for the initial and subsequent measurement of these types of arrangements. The seller should apply the chosen policy option to all future transactions. In addition, if a reporting entity believes it can support an alternative accounting treatment for a specific contingent consideration arrangement (other than the two approaches described below), it should consult with independent accountants. The two approaches are as follows:

• **Approach 1** — The seller includes the initial fair value of any contingent consideration arrangement as part of the overall gain or loss on deconsolidation of a subsidiary. Supporters of this approach point to ASC 810-10-40-5, which states that the seller (parent) should include the “fair value of any consideration received” when calculating the gain or loss on deconsolidation of a subsidiary (emphasis added). Accordingly, the “consideration received” should include the fair value of any contingent consideration arrangements between the seller and buyer. Under this approach, the seller would recognize a contingent consideration receivable for the future amounts due from the buyer.

If the seller adopts this approach to initially account for a contingent consideration agreement, it should elect an accounting policy to (1) subsequently remeasure the contingent consideration at fair value as of the end of each reporting period or (2) subsequently apply the gain contingency guidance in ASC 450-30.

• **Approach 2** — The seller accounts for the contingent consideration arrangement as a gain contingency in accordance with ASC 450. This approach is consistent with the accounting that entities applied to such transactions before the FASB issued Statement 160 (codified in ASC 810). Under this approach, the seller typically recognizes the contingent consideration receivable in earnings after the contingency is resolved. Accordingly, to determine the initial gain or loss on deconsolidation of a subsidiary, the seller would not include an amount related to the contingent consideration arrangement as part of the consideration received unless the recognition criteria in ASC 450 are met. Supporters of this approach believe that the FASB did not intend to change practice when it issued Statement 160 (codified in ASC 810).
If the seller selects this approach to initially account for a contingent consideration agreement, it should continue to apply this approach in subsequent periods until the contingency is resolved.

**Example F-6**

Parent A has a wholly owned subsidiary with a carrying amount of $100. Parent A decides to sell 100 percent of this subsidiary to Company B, a third-party buyer. As part of the purchase agreement, B agrees to pay A (1) $150 upon the close of the transaction and (2) an additional $50 if the subsidiary’s earnings exceed a specified level for the 12-month period after the close of the transaction. Upon the close of the transaction, A calculates the fair value of the contingent consideration portion of the arrangement to be $30. In addition, the arrangement does not meet the definition of a derivative and is not a separate transaction.

Parent A would compute its initial gain on the sale, which would be recognized upon the close of the transaction, under the two approaches as follows:

<table>
<thead>
<tr>
<th></th>
<th>Approach 1</th>
<th>Approach 2</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash proceeds</td>
<td>$ 150</td>
<td>$ 150</td>
</tr>
<tr>
<td>Contingent</td>
<td>30</td>
<td>—</td>
</tr>
<tr>
<td>consideration</td>
<td></td>
<td></td>
</tr>
<tr>
<td>receivable</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Total consideration</td>
<td>180</td>
<td>150</td>
</tr>
<tr>
<td>Less: subsidiary’s</td>
<td>(100)</td>
<td>(100)</td>
</tr>
<tr>
<td>carrying amount</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Initial gain on sale</td>
<td>$ 80</td>
<td>$ 50</td>
</tr>
</tbody>
</table>

**F.4 Parent’s Disclosures and SEC Reporting Considerations Upon Deconsolidation of a Subsidiary**

ASC 810-10-50-1B provides the following disclosure requirements for a parent that deconsolidates a subsidiary.

**ASC 810-10**

**50-1B** In the period that either a subsidiary is deconsolidated or a group of assets is derecognized in accordance with paragraph 810-10-40-3A, the parent shall disclose all of the following:

a. The amount of any gain or loss recognized in accordance with paragraph 810-10-40-5
b. The portion of any gain or loss related to the remeasurement of any retained investment in the former subsidiary or group of assets to its fair value
c. The caption in the income statement in which the gain or loss is recognized unless separately presented on the face of the income statement
d. A description of the valuation technique(s) used to measure the fair value of any direct or indirect retained investment in the former subsidiary or group of assets
e. Information that enables users of the parent’s financial statements to assess the inputs used to develop the fair value in item (d)
f. The nature of continuing involvement with the subsidiary or entity acquiring the group of assets after it has been deconsolidated or derecognized
g. Whether the transaction that resulted in the deconsolidation or derecognition was with a related party
h. Whether the former subsidiary or entity acquiring a group of assets will be a related party after deconsolidation.
F.4.1 SEC Reporting Requirements Upon Deconsolidation of a Subsidiary

When either a subsidiary is deconsolidated or a group of assets is derecognized, SEC registrants may be required to report a deconsolidation or derecognition on a Form 8-K and provide pro forma financial information that gives effect to the deconsolidation or derecognition. Upon the deconsolidation of a subsidiary, or when a significant disposition has occurred or its occurrence is probable, registrants may be required to provide pro forma financial information in a registration statement, proxy statement, or Form 8-K if the historical financial statements do not yet reflect the transaction.

The flowchart below outlines considerations related to the reporting obligations a registrant could have under Form 8-K, Item 2.01, when it completes a disposition. In the flowchart, it is assumed that an entity is required to file a Form 8-K to report the disposition. If the requirements for filing under Form 8-K, Item 2.01, are met, pro forma financial information prepared under Form 8-K, Item 9.01, must be filed within four business days of the consummation of the disposition.

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3 The definition of a business for SEC purposes is outlined in SEC Regulation S-X, Rule 11-01(d). This definition can differ from the definition in accounting literature, including that in ASC 805-10.

4 Under Rule 11-01(b), a disposed-of business is significant if the business to be disposed of meets the conditions for a significant subsidiary in Regulation S-X, Rule 1-02(w), in accordance with any of the significance tests.

5 Instruction 4 of Item 2.01 indicates that if either of the following exceeds 10 percent of the registrant’s consolidated assets, the disposition of assets would be considered significant: (1) the equity in the net book value of the assets or (2) the amount paid that is received for the assets upon disposition.
F.4.2 Form 8-K Reporting Obligations

SEC registrants are required to periodically file current reports on Form 8-K to inform investors of certain events. For example, Item 2.01 of Form 8-K requires a registrant to file a Form 8-K within four business days after a consummated \(^6\) disposition of (1) a significant amount of assets or (2) a business that is significant. Item 2.01, Instruction 2, defines a disposition as follows:

The term *disposition* includes every sale, disposition by lease, exchange merger, consolidation, mortgage, assignment or hypothecation of assets, whether for the benefit of creditors or otherwise, abandonment, destruction, or other disposition.

The deconsolidation of a subsidiary or derecognition of a group of assets would therefore be considered a disposition. Consequently, if deconsolidation or derecognition occurs as a result of a loss of control (e.g., a reconsideration event as described in Chapter 9), the registrant must consider the requirements in Form 8-K, Item 2.01. See the highlights of the March 2015 CAQ SEC Regulations Committee joint meeting with the SEC staff.

The nature of the registrant’s disclosures depends on whether the deconsolidated entity or derecognized assets (1) represents a business for SEC reporting purposes or (2) is significant. The definition of a business in Regulation S-X, Rule 11-01(d), for SEC reporting purposes differs from the definition of a business in ASC 805-10 for U.S. GAAP accounting purposes. Accordingly, the registrant must first perform an evaluation under Rule 11-01(d) to determine its SEC reporting requirements. See Section 1.3.1 of Deloitte’s *A Roadmap to SEC Reporting Considerations for Business Combinations*.

Item 2.01, Instruction 4, further states, in part:

An acquisition or disposition shall be deemed to involve a significant amount of assets:

(i) if the registrant’s and its other subsidiaries’ equity in the net book value of such assets or the amount paid or received for the assets upon such acquisition or disposition exceeded 10% of the total assets of the registrant and its consolidated subsidiaries; or

(ii) if it involved a business (see 17 CFR 210.11-01(d)) that is significant (see 17 CFR 210.11-01(b)).

If the deconsolidated entity or derecognized assets do not meet the definition of a business for SEC reporting purposes, the deconsolidation or derecognition should be regarded as an asset disposition and reported under Form 8-K, Item 2.01, if it exceeds the 10 percent threshold specified in the two significance tests in Instruction 4. These tests are similar to the asset and investment tests in Regulation S-X, Rule 1-02(w).

If the deconsolidated entity or derecognized assets meet the definition of a business for SEC reporting purposes, the deconsolidation or derecognition should be regarded as a business disposition, if significant.

Under condition (ii) mentioned above, the disposition of a business is significant if any of the results of the three significance tests in Regulation S-X, Rule 1-02(w) (i.e., the asset, income, or investment test), exceed 10 percent.\(^7\) Registrants are not required to provide the historical financial statements of the

\(^6\) A Form 8-K may also be required under Item 1.01 when a registrant has entered into a material definitive agreement for a disposition (e.g., when it executes a contract to dispose of the assets or business). An Item 1.01 Form 8-K is generally filed earlier than an Item 2.01 Form 8-K, which is not required until the disposition is consummated. Since Item 2.01 triggers a requirement to provide financial statements in accordance with Item 9.01 (typically pro forma financial statements), such financial statements are not required in the Item 1.01 Form 8-K. Registrants may wish to consult with their legal advisers regarding these requirements.

\(^7\) In May 2020, the SEC published a final rule that changes the significance threshold for a business disposition to 20 percent. For more information about the final rule, see Deloitte’s June 2, 2020, *Heads Up*. 
disposed-of business in the Form 8-K. For additional guidance on the disposition of a business, see Section 2100 of the FRM.

In addition, Form 8-K, Item 9.01, requires registrants to provide, in accordance with Regulation S-X, Article 11, pro forma financial information for any transaction required to be described under Form 8-K, Item 2.01 (see Section F.4.3 below for guidance on pro forma requirements). The Form 8-K, including the pro forma financial information, must be filed within four business days after the consummation of the disposition. The 71-day extension in Item 9.01 that is available for acquisitions is not available for dispositions (see Question 129.01 of the SEC staff's Compliance and Disclosure Interpretations of Form 8-K).

For a deconsolidation or derecognition, a registrant would generally need to file Item 2.01 within four business days after occurrence of the reconsideration event. A registrant's filing may be delayed if it does not identify the reconsideration event until the interim or annual financial reporting closing process. A registrant should consult with legal counsel if it believes that it can use, as an alternative, the date it files financial statements reflecting the deconsolidation. See the highlights of the June 2009 and September 2009 CAQ SEC Regulations Committee joint meetings with the SEC staff.

F.4.3 Pro Forma Financial Information Under Regulation S-X, Article 11

The objective of providing pro forma financial information is to enable investors to understand and evaluate the impact of a transaction by showing how that specific transaction (or group of transactions) might have affected the registrant's historical financial position and results of operations had the transaction occurred at an earlier date. Regulation S-X, Article 11, which establishes the requirements for pro forma information, lists several circumstances in which a registrant may be required to provide pro forma financial information, including when there is a disposition of a significant portion of a business or when there are other events that have occurred for which pro forma information would be material to investors. Pro forma financial information for a significant disposition may be required in a registration statement, proxy statement, or Form 8-K. For additional SEC interpretive guidance on Article 11, see Topic 3 of the FRM and Chapter 3 of Deloitte's A Roadmap to SEC Reporting Considerations for Business Combinations.

F.4.3.1 Periods to Be Presented in Pro Forma Financial Information

In general, a pro forma balance sheet should be presented for only the most recent balance sheet required by Regulation S-X, Rule 3-01 (i.e., one pro forma balance sheet as of the end of the fiscal year or the subsequent interim period, whichever is later) for a disposition of a significant business. In lieu of the pro forma balance sheet, the registrant may also consider including a narrative discussion that reflects the effects of the disposition (e.g., in cases in which the pro forma adjustments are easily understood). Pro forma income statements generally should be presented for only the most recent fiscal year and interim period that must be presented. However, paragraph 3230.2 of the FRM states that "[p]ro forma presentation of all periods is required . . . for discontinued operations (SFAS 144 [ASC 205-20]) that are not yet reflected in the annual historical statements" (emphasis added). Accordingly, if a deconsolidation meets the discontinued-operations criteria in ASC 205-20, three years of pro forma income statements must be presented. However, if the deconsolidation does not meet these criteria, only one year of a pro forma income statement is required. The appropriate subsequent interim periods must be presented in both scenarios. For additional information about discontinued operations, see Deloitte's A Roadmap to Disposals of Long-Lived Assets and Discontinued Operations.

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8 If a registrant is soliciting authorization for a disposal of a significant business in a proxy statement, unaudited financial statements of the business to be disposed of for each of the two most recent fiscal years (audited if available) and the appropriate unaudited interim periods should be provided. See paragraphs 1140.6 and 2120.2 of the FRM.

9 See footnote 6.
In the period in which a disposition of a component meets the criteria in ASC 205-20 for presentation as a discontinued operation, a registrant must present the component as a discontinued operation retrospectively for all prior periods presented. Accordingly, SEC registrants must consider the impact of the retrospective change on the historical financial statements included in their Exchange Act reports (e.g., Forms 10-K and 10-Q) and in registration statements under the Securities Act (e.g., registration statements on Form S-3) and other nonpublic offerings. See Chapter 8 of Deloitte's *A Roadmap to Disposals of Long-Lived Assets and Discontinued Operations*.

When derecognition of an asset that does not represent a business for SEC reporting purposes is significant and would therefore be material to investors, the registrant may consider including limited pro forma balance sheet information reflecting the effects of the disposition (or, e.g., a narrative discussion if adjustments are easily understood).

As noted in Section F.4.2, registrants must provide pro forma information for a significant deconsolidation or derecognition in the Form 8-K that must generally be filed four business days after occurrence of the reconsideration event. They should also be aware that the automatic 71-day extension in Form 8-K, Item 9.01 that is available for acquisitions, is not available for a significant disposition.

**F.4.4 Regulation S-X, Rules 3-09, 4-08(g), and 10-01(b)(1) — Financial Statements and Summarized Financial Information for Equity Method Investments**

Under Regulation S-X, Rules 3-09 and 4-08(g), SEC registrants are required to evaluate the significance of an equity method investee in accordance with the tests in Regulation S-X, Rule 1-02(w) (i.e., the asset, income, and investment tests), to determine whether they must provide, in any reports filed with the SEC that include the registrant's annual financial statements, the investee's (1) financial statements, (2) summarized financial information, or (3) both. Similarly, under Regulation S-X, Rule 10-01(b)(1), a registrant performs the investment and income tests to determine whether summarized information is needed for interim periods. If a registrant must deconsolidate a legal entity and subsequently apply the equity method of accounting, the registrant would need to evaluate the significance of its investee and comply with the requirements of Rules 3-09, 4-08(g), and 10-01(b)(1). The registrant would also need to comply with the disclosure requirements in these rules as well as those in ASC 323 for investees. For additional information about reporting for equity method investments, see Section 1.1 of Deloitte's *A Roadmap to SEC Reporting Considerations for Equity Method Investees*.

Because the calculation for the income test is based on a measure of income from continuing operations, the reporting of a discontinued operation could affect the results of the significance test for a registrant's investees. Accordingly, registrants should consider the guidance in Section 8.5.2 of Deloitte's *A Roadmap to Disposals of Long-Lived Assets and Discontinued Operations* if a deconsolidation meets the discontinued operations criteria in ASC 205-20.
Appendix G — Comparison of U.S. GAAP and IFRS Standards

Under IFRS® Standards, the primary source of guidance on determining when and how to prepare consolidated financial statements is IFRS 10. In addition, IFRS 12 provides guidance on a wide range of disclosures about an entity's interests in subsidiaries, joint arrangements, associates, and unconsolidated “structured entities.” Further, IAS 27 addresses the preparation of separate financial statements.

The FASB has, to date, elected not to converge its consolidation guidance with the IASB’s. A notable difference between the guidance in U.S. GAAP and IFRS Standards is that under IFRS 10, entities apply a single, control-based model for determining whether to consolidate a legal entity. In other words, the assessment under IFRS 10 is less complex than that under U.S. GAAP since it does not require an analysis of whether a legal entity is a VIE or voting interest entity. Further, the different requirements under the two sets of standards may result in different consolidation conclusions, although frequently the same reporting entity would consolidate a legal entity under both U.S. GAAP and IFRS Standards.

The table below summarizes the key differences between U.S. GAAP and IFRS Standards in the determination of whether to consolidate a legal entity.¹ For comprehensive consolidation guidance under IFRS Standards, see IFRS 10. For detailed interpretive guidance on IFRS 10, see Chapter A24, “Consolidated Financial Statements,” of Deloitte’s iGAAP publication (subscription required).

¹ Differences are based on a comparison of authoritative literature under U.S. GAAP and IFRS Standards and do not necessarily include interpretations of such literature.
### Determining Whether to Consolidate a Legal Entity — Differences Between U.S. GAAP and IFRS Standards

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<thead>
<tr>
<th>Subject</th>
<th>U.S. GAAP</th>
<th>IFRS Standards</th>
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<tbody>
<tr>
<td>Scope exceptions</td>
<td>A reporting entity may be exempt from analyzing a legal entity for consolidation as a result of a general scope exception that applies to legal entities that are (1) employee benefit plans, (2) governmental entities, or (3) money market funds (in certain cases).</td>
<td>Paragraph 4A of IFRS 10 provides a general scope exception for postemployment benefit plans or other long-term employee benefit plans.</td>
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<td>Investment companies do not consolidate investees that are not investment companies (but note that there are some differences between the U.S. GAAP and IFRS definitions of an investment company).</td>
<td>Investment companies present consolidated financial statements.</td>
</tr>
<tr>
<td></td>
<td>In addition, there are certain VIE scope exceptions.</td>
<td>As discussed below, since IFRS 10 does not have a separate VIE model, VIE scope exceptions are inapplicable.</td>
</tr>
<tr>
<td>Determining when to consolidate a legal entity</td>
<td>There are two primary models for determining when consolidation is appropriate — the VIE and the voting interest entity models. If a reporting entity has an interest in a VIE, it must apply the VIE consolidation model, which is based on power and economics. If a reporting entity has an interest in an entity that is not a VIE, it must apply the voting control-based consolidation model (i.e., the voting interest entity model).</td>
<td>IFRS 10 contains a single, control-based model for determining whether consolidation of an investee is appropriate. However, IFRS 10 provides additional guidance that is applicable when the relevant activities of an investee are directed through voting rights and when voting rights do not have a significant effect on returns.</td>
</tr>
<tr>
<td>Definition of control — general principle</td>
<td>Under the voting interest entity model, a controlling financial interest is defined as &quot;ownership of a majority voting interest&quot; in another entity. ASC 810-10 further indicates that the power to control another entity may exist in other contracts or agreements outside of a majority voting interest.</td>
<td>Paragraph 7 of IFRS 10 explains that an investor controls an investee if it has all of the following elements: (1) power over the investee; (2) exposure, or rights, to variable returns from its involvement with the investee; and (3) the ability to use its power over the investee to affect the investor's returns. An investor must consider all facts and circumstances, including the purpose and design of the investee (for identification of relevant activities), how decisions about relevant activities are made, and who receives returns from those activities when assessing whether it controls the investee.</td>
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<td>The VIE model in ASC 810-10 states that a reporting entity has a controlling financial interest if it has both of the following characteristics: (1) the power to direct the activities of the VIE that most significantly affect the VIE's economic performance and (2) the obligation to absorb losses of, or the right to receive benefits from, the VIE that could potentially be significant to the VIE.</td>
<td>This principle is similar to the U.S. GAAP control analysis under the VIE model.</td>
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<td>However, several differences exist, including the analysis of potential voting rights, de facto power, and the effects of agency relationships.</td>
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Determining Whether to Consolidate a Legal Entity — Differences Between U.S. GAAP and IFRS Standards

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<tr>
<td>Control analysis — shared power</td>
<td>If a reporting entity determines that power is shared among multiple unrelated parties involved with a VIE, no party consolidates the VIE. Under the VIE model in ASC 810-10, power is considered shared if (1) two or more unrelated parties together have the power to direct the VIE’s most significant activities and (2) decisions about those activities require the consent of each of the parties sharing power.</td>
<td>Paragraph 9 of IFRS 10 indicates that when two or more investors collectively control an investee (i.e., they must act together to direct the relevant activities of an entity), no investor individually controls the investee. If power is shared (i.e., joint control), IFRS 11 applies.</td>
</tr>
<tr>
<td>Control analysis — potential voting rights</td>
<td>Under U.S. GAAP, a reporting entity that applies the voting interest entity model is generally not required to consider the effect of potential voting rights (e.g., warrants, share call options, or other instruments convertible into voting shares) when determining whether a controlling financial interest exists. For example, under the voting interest entity model in ASC 810-10, a reporting entity is not required to consider the additional voting shares it would receive in an investee upon exercise of a stock purchase warrant when determining whether it holds a majority ownership interest in the investee. However, potential voting rights associated with unexercised options and unsettled forwards may be an indicator of control. See Section D.1.4 for additional discussion. The VIE model in ASC 810-10 also does not specifically address the impact of potential voting rights on the determination of which party has the power to direct the most significant activities of an entity. However, the reporting entity must carefully consider the effect of these rights (see Section 7.2.9).</td>
<td>Paragraphs B47–B50 of IFRS 10 require potential voting rights, such as those resulting from convertible instruments or options, to be considered in the assessment of control; IFRS 10 does not limit potential voting rights to those that are currently exercisable or convertible. (All relevant facts and circumstances need to be considered in the assessment of whether control exists as a result of potential voting rights.) Potential voting rights must be “substantive” to be considered. Paragraphs B22–B25 of IFRS 10 provide guidance on determining whether rights are substantive. A reporting entity with less than a majority of the voting shares would be required to consolidate the investee if it also has potential voting rights that, alone or in combination with its voting shares, give the reporting entity the current ability to direct the investee’s relevant activities. For example, assume that Entity A and Entity B hold 60 percent and 40 percent, respectively, of the outstanding voting shares of Entity C. Entity B has an option to purchase half of A’s voting rights. The option is in the money (i.e., it would be favorable for B to currently exercise the option) and there are no barriers that prevent B from exercising its option. If the combination of the voting shares and the option give B the current ability to direct C’s relevant activities, B should consolidate C.</td>
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### Determining Whether to Consolidate a Legal Entity — Differences Between U.S. GAAP and IFRS Standards

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<tr>
<td>Control analysis — de facto power</td>
<td>This concept does not exist under U.S. GAAP.</td>
<td>An investor with less than a majority of voting rights that has not entered into additional contractual arrangements may still have power over the legal entity if its voting rights give it “the practical ability to direct the relevant activities unilaterally” (see paragraph B41 of IFRS 10). This circumstance may arise when the investor's holdings of voting rights are significantly greater relative to the size and dispersion of holdings of the other investors. Paragraphs B42–B46 of IFRS 10 provide detailed guidance on determining whether de facto power exists. For example, assume that Entity A acquires 46 percent of the voting rights of Entity C, and the remaining 54 percent of the voting rights are dispersed among thousands of shareholders (no other shareholder holds more than 1 percent). Upon acquiring its interest in C, A determined that, on the basis of its specific relevant facts and circumstances (including the size of its ownership relative to that of others), its 46 percent interest would be sufficient to give it a dominant voting interest that meets the power criterion regardless of whether it considers any other evidence of power.</td>
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### Determining Whether to Consolidate a Legal Entity — Differences Between U.S. GAAP and IFRS Standards

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<tr>
<td>Control analysis — related parties and agency relationships</td>
<td>There are no prescriptive related-party rules under the voting interest entity model related to determining whether a reporting entity should consolidate a legal entity. However, the VIE model includes provisions that require related parties and de facto agents to be considered throughout the consolidation analysis. Interests held by related parties (regardless of whether the reporting entity can cause the related party to vote on its behalf) may result in the consolidation of the VIE by one of the related parties involved with the VIE, even if none of the parties individually have a controlling financial interest over the VIE. If a reporting entity concludes that it does not meet the primary-beneficiary criteria but that the related-party group (including de facto agents) meets the criteria as a group, the reporting entity may be required to determine which party is most closely associated with the VIE and therefore must consolidate the VIE. This determination requires the application of judgment and an evaluation of all relevant facts and circumstances, including the factors listed in ASC 810-10-25-44. Section 7.4.2.1 discusses situations in which a reporting entity is required to perform the related-party tiebreaker test (i.e., the analysis of which party is most closely associated with a VIE), and Section 7.4.2.4 discusses how to perform that test.</td>
<td>IFRS 10 includes a similar list of related parties and de facto agents to those included in ASC 810 under U.S. GAAP. However, IFRS 10 does not assume that the related parties will act in concert. Instead, paragraph B73 of IFRS 10 states, “When assessing control, an investor shall consider the nature of its relationship with other parties and whether those other parties are acting on the investor’s behalf (i.e., they are ‘de facto agents’). The determination of whether other parties are acting as de facto agents requires judgement, considering not only the nature of the relationship but also how those parties interact with each other and the investor.” The practical impact is that an entity may be less likely to be consolidated by a reporting entity under IFRS 10 because the power and economics of the related party are only attributed to the reporting entity if the related party is acting as its de facto agent. Further, unlike U.S. GAAP, IFRS 10 does not require performance of the related-party tiebreaker test.</td>
</tr>
<tr>
<td>Presentation requirements for certain consolidated entities</td>
<td>Under the VIE model, the primary beneficiary of a VIE is required to separately present on the face of the balance sheet (1) assets of the consolidated VIE that can only be used to settle obligations of the VIE and (2) liabilities of the consolidated VIE for which creditors do not have recourse to the general credit of the primary beneficiary.</td>
<td>Presentation requirements for special-purpose entities are not specifically addressed.</td>
</tr>
<tr>
<td>Accounting policies</td>
<td>Upon consolidation, the accounting policies of a parent and its subsidiaries should be conformed in the parent’s consolidated financial statements unless differences between the policies can be justified.</td>
<td>Upon consolidation, paragraph 19 of IFRS 10 requires the accounting policies of a parent and its subsidiaries to be conformed with respect to “using uniform accounting policies for like transactions and other events in similar circumstances.”</td>
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### Determining Whether to Consolidate a Legal Entity — Differences Between U.S. GAAP and IFRS Standards

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<td>Different reporting dates</td>
<td>Consolidation is not prohibited if a parent and subsidiary have different reporting periods. When a difference in reporting periods is three months or less, it is usually acceptable for a parent to consolidate a subsidiary on the basis of the subsidiary's financial statements; however, the difference is not to exceed three months.</td>
<td>Paragraphs B92 and B93 of IFRS 10 explain that when consolidating a subsidiary, a parent is required to align the subsidiary's reporting date with its own (if the subsidiary has a different reporting period) unless doing so is impractical. If it is impractical for the subsidiary and parent to have the same reporting period, the difference between the periods can be no greater than three months, and adjustments should be made for significant transactions.</td>
</tr>
<tr>
<td>Private-company alternatives</td>
<td>There is an accounting alternative to the VIE model for private-company lessors under common control. See Section 3.5.</td>
<td>The concept does not exist under IFRS Standards.</td>
</tr>
<tr>
<td>Specific limited partnership (or similar entity) guidance</td>
<td>A limited partnership would be considered a VIE unless a simple majority or lower threshold of the “unrelated” limited partners have substantive kick-out rights (including liquidation rights) or participating rights. For entities other than limited partnerships, a two-step process must be used to evaluate whether the equity holders (as a group) have power.</td>
<td>The concept does not exist under IFRS Standards.</td>
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2 Upon the adoption of ASU 2018-17, the accounting alternative for private companies will be expanded to include all legal entities under common control that meet certain criteria. See Section 3.5.2 for details.
### Determining Whether to Consolidate a Legal Entity — Differences Between U.S. GAAP and IFRS Standards

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<tr>
<td>Silos</td>
<td>The concept of a “silo” appears only in the VIE subsections of ASC 810-10. The FASB established this concept in response to concerns that reporting entities could avoid consolidation by combining separate pools of assets or activities into a single legal entity while effectively segregating the right to govern the activities, the right to receive the benefits, and the obligation to absorb the losses of each separate pool of assets or activities, effectively creating a VIE within a VIE. Such scenarios will generally only result from either (1) specific regulatory constructs or (2) deliberate legal structuring (see Section 6.2.3). Accordingly, silos typically exist in very limited circumstances. If a silo exists within a VIE, a reporting entity with a variable interest in the silo should determine whether consolidating it separately from the legal entity as a whole is appropriate.</td>
<td>The concept does not exist under IFRS Standards.</td>
</tr>
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<tr>
<th>Decision maker/service provider</th>
<th>The evaluation of whether fees paid to a decision maker or service provider are a variable interest focuses on whether all of the following are met:</th>
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<tr>
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<td>• The fees are commensurate with the level of service provided.</td>
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<td>• The fees are negotiated at arm’s length (i.e., they are at market).</td>
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<td>• The decision maker or service provider does not have any other interests (direct interests, indirect interests through its related parties, or certain interests held by its related parties under common control) in the legal entity that absorb more than an insignificant amount of the potential VIE’s variability.</td>
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<td>If it is determined that a decision maker’s fee arrangement is not a variable interest, the decision maker would be acting as a fiduciary for the legal entity. This determination could affect whether the legal entity is a VIE (see Section 5.3.1.1.3.1) and whether the decision maker is required to consolidate the VIE.</td>
</tr>
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Appendix H — Titles of Standards and Other Literature

**AICPA Literature**

**AcSEC Issues Paper**
“Joint Venture Accounting”

**Audit and Accounting Guides**

*Health Care Entities*
*Not-for-Profit Entities*
*State and Local Governments*

**FASB Literature**

**ASC Topics**

*ASC 205, Presentation of Financial Statements*
*ASC 220, Income Statement — Reporting Comprehensive Income*
*ASC 235, Notes to Financial Statements*
*ASC 250, Accounting Changes and Error Corrections*
*ASC 280, Segment Reporting*
*ASC 320, Investments — Debt and Equity Securities*
*ASC 321, Investments — Equity Securities*
*ASC 323, Investments — Equity Method and Joint Ventures*
*ASC 350, Intangibles — Goodwill and Other*
*ASC 360, Property, Plant, and Equipment*
*ASC 450, Contingencies*
*ASC 470, Debt*
*ASC 480, Distinguishing Liabilities From Equity*
*ASC 605, Revenue Recognition*
*ASC 606, Revenue From Contracts With Customers*
ASC 610, Other Income
ASC 710, Compensation — General
ASC 712, Compensation — Nonretirement Postemployment Benefits
ASC 715, Compensation — Retirement Benefits
ASC 718, Compensation — Stock Compensation
ASC 805, Business Combinations
ASC 810, Consolidation
ASC 815, Derivatives and Hedging
ASC 820, Fair Value Measurement
ASC 825, Financial Instruments
ASC 830, Foreign Currency Matters
ASC 840, Leases
ASC 842, Leases
ASC 845, Nonmonetary Transactions
ASC 850, Related Party Disclosures
ASC 852, Reorganizations
ASC 855, Subsequent Events
ASC 860, Transfers and Servicing
ASC 910, Contractors — Construction
ASC 915, Development Stage Entities
ASC 932, Extractive Activities — Oil and Gas
ASC 940, Financial Services — Brokers and Dealers
ASC 944, Financial Services — Insurance
ASC 946, Financial Services — Investment Companies
ASC 952, Franchisors
ASC 954, Health Care Entities
ASC 958, Not-for-Profit Entities
ASC 960, Plan Accounting — Defined Benefit Pension Plans
ASC 962, Plan Accounting — Defined Contribution Pension Plans
ASC 965, Plan Accounting — Health and Welfare Benefit Plans
ASC 970, Real Estate — General
ASC 972, Real Estate — Common Interest Realty Associations
ASC 976, Real Estate — Retail Land
ASUs

ASU 2009-17, Consolidation (Topic 810): Improvements to Financial Reporting by Enterprises Involved With Variable Interest Entities

ASU 2010-10, Consolidation (Topic 810): Amendments for Certain Investment Funds

ASU 2010-15, Financial Services — Insurance (Topic 924): How Investments Held Through Separate Accounts Affect an Insurer’s Consolidation Analysis of Those Investments — a consensus of the FASB Emerging Issues Task Force

ASU 2014-01, Investments — Equity Method and Joint Ventures (Topic 323): Accounting for Investments in Qualified Affordable Housing Projects — a consensus of the FASB Emerging Issues Task Force

ASU 2014-07, Consolidation (Topic 810): Applying Variable Interest Entities Guidance to Common Control Leasing Arrangements — a consensus of the Private Company Council

ASU 2014-09, Revenue From Contracts With Customers (Topic 606)

ASU 2014-10, Development Stage Entities (Topic 915): Elimination of Certain Financial Reporting Requirements, Including an Amendment to Variable Interest Entities Guidance in Topic 810, Consolidation


ASU 2015-02, Consolidation (Topic 810): Amendments to the Consolidation Analysis


ASU 2016-02, Leases (Topic 842)

ASU 2016-03, Intangibles — Goodwill and Other (Topic 350); Business Combinations (Topic 805); Consolidation (Topic 810); Derivatives and Hedging (Topic 815): Effective Date and Transition Guidance — a consensus of the Private Company Council

ASU 2016-17, Consolidation (Topic 810): Interests Held Through Related Parties That Are Under Common Control

ASU 2017-01, Business Combinations (Topic 805): Clarifying the Definition of a Business

ASU 2017-02, Not-for-Profit Entities — Consolidation (Subtopic 958-810): Clarifying When a Not-for-Profit Entity That Is a General Partner or a Limited Partner Should Consolidate a For-Profit Limited Partnership or Similar Entity

ASU 2017-05, Other Income — Gains and Losses From the Derecognition of Nonfinancial Assets (Subtopic 610-20): Clarifying the Scope of Asset Derecognition Guidance and Accounting for Partial Sales of Nonfinancial Assets

ASU 2018-17, Consolidation (Topic 810): Targeted Improvements to Related Party Guidance for Variable Interest Entities

ASU 2019-10, Financial Instruments — Credit Losses (Topic 326), Derivatives and Hedging (Topic 815), and Leases (Topic 842): Effective Dates

ASU 2020-05, Revenue From Contracts With Customers (Topic 606) and Leases (Topic 842): Effective Dates for Certain Entities
Proposed ASU
No. 2017-280, Consolidation (Topic 812): Reorganization

GASB Literature
Staff Paper, Applicability of GASB Standards

IFRS Literature
IFRS 10, Consolidated Financial Statements
IFRS 11, Joint Arrangements
IFRS 12, Disclosure of Interests in Other Entities
IAS 27, Separate Financial Statements

SEC Literature
FRM
Topic 1, “Registrant’s Financial Statements”
Topic 2, “Other Financial Statements Required”
Topic 3, “Pro Forma Financial Information”

Final Rules
No. 33-10786, Amendments to Financial Disclosures About Acquired and Disposed Businesses
No. 34-73407, Credit Risk Retention

Regulation S-X
Rule 1-02, “Definitions of Terms Used in Regulation S-X (17 CFR Part 210)”
  • Rule 1-02(g), “Control”
  • Rule 1-02(w), “Significant Subsidiary”
Rule 3-01, “Consolidated Balance Sheets”
Rule 3-05, “Financial Statements of Businesses Acquired or to Be Acquired”
Rule 3-09, “Separate Financial Statements of Subsidiaries Not Consolidated and 50 Percent or Less Owned Persons”
Rule 3-10, “Financial Statements of Guarantors and Issuers of Guaranteed Securities Registered or Being Registered”
Rule 3-13, “Filing of Other Financial Statements in Certain Cases”
Rule 3A-02, “Consolidated Financial Statements of the Registrant and Its Subsidiaries”
Rule 4-08(g), “Summarized Financial Information of Subsidiaries Not Consolidated and 50 Percent or Less Owned Persons”
Rule 5-02, “Commercial and Industrial Companies: Balance Sheets”
Article 11, “Pro Forma Financial Information”
Rule 11-01, “Presentation Requirements”
SAB Topics
No. 1.B, “Allocation of Expenses and Related Disclosure In Financial Statements of Subsidiaries, Divisions or Lesser Business Components of Another Entity”
No. 5.G, “Transfers of Nonmonetary Assets by Promoters or Shareholders”

Investment Management Staff Guidance Updates
2014-11, “Investment Company Consolidation”

Superseded Literature

AICPA Accounting Research Bulletin (ARB)
No. 51, Consolidated Financial Statements

AICPA Statements of Position
78-9, Accounting for Investments in Real Estate Ventures
90-7, Financial Reporting by Entities in Reorganization Under the Bankruptcy Code

FASB Statements
No. 57, Related Party Disclosures
No. 94, Consolidation of All Majority-Owned Subsidiaries
No. 125, Accounting for Transfers and Servicing of Financial Assets and Extinguishment of Liabilities
No. 142, Goodwill and Other Intangible Assets
No. 144, Accounting for the Impairment or Disposal of Long-Lived Assets
No. 160, Noncontrolling Interests in Consolidated Financial Statements
No. 167, Amendments to FASB Interpretation No. 46(R)

FASB Concepts Statement
No. 7, Using Cash Flow Information and Present Value in Accounting Measurements

FASB Interpretations
Interpretation No. 46, Consolidation of Variable Interest Entities — an interpretation of ARB No. 51
Interpretation No. 46(R), Consolidation of Variable Interest Entities — an interpretation of ARB No. 51

EITF Issues and D-Topics
88-15, “Classification of Subsidiary’s Loan Payable in Consolidated Balance Sheet When Subsidiary’s and Parent’s Fiscal Years Differ”
95-6, “Accounting by a Real Estate Investment Trust for an Investment in a Service Corporation”
96-16, “Investor’s Accounting for an Investee When the Investor Has a Majority of the Voting Interest but the Minority Shareholder or Shareholders Have Certain Approval Rights”

96-21, “Implementation Issues in Accounting for Leasing Transactions Involving Special-Purpose Entities”

97-2, “Application of FASB Statement No. 94 and APB Opinion No. 16 to Physician Practice Management Entities and Certain Other Entities With Contractual Management Arrangements”

98-4, “Accounting by a Joint Venture for Businesses Received at Its Formation”

04-5, “Determining Whether a General Partner, or the General Partners as a Group, Controls a Limited Partnership or Similar Entity When the Limited Partners Have Certain Rights”

09-4, “Seller Accounting for Contingent Consideration”

10-E, “Accounting for Deconsolidation of a Subsidiary That Is In-Substance Real Estate”

Topic D-14, “Transactions Involving Special-Purpose Entities”

Topic D-96, “Accounting for Management Fees Based on a Formula”
## Appendix I — Abbreviations

<table>
<thead>
<tr>
<th>Abbreviation</th>
<th>Description</th>
</tr>
</thead>
<tbody>
<tr>
<td>ABS</td>
<td>asset-backed security</td>
</tr>
<tr>
<td>AcSEC</td>
<td>Accounting Standards Executive Committee</td>
</tr>
<tr>
<td>AFS</td>
<td>available for sale</td>
</tr>
<tr>
<td>AICPA</td>
<td>American Institute of Certified Public Accountants</td>
</tr>
<tr>
<td>AMIAPG</td>
<td>Asset Management Industry Accounting Policy Group</td>
</tr>
<tr>
<td>ARB</td>
<td>Accounting Research Bulletin</td>
</tr>
<tr>
<td>ASC</td>
<td>FASB Accounting Standards Codification</td>
</tr>
<tr>
<td>ASU</td>
<td>FASB Accounting Standards Update</td>
</tr>
<tr>
<td>CAQ</td>
<td>Center for Audit Quality</td>
</tr>
<tr>
<td>CDO</td>
<td>collateralized debt obligation (entity)</td>
</tr>
<tr>
<td>CEO</td>
<td>chief executive officer</td>
</tr>
<tr>
<td>CFE</td>
<td>collateralized financing entity</td>
</tr>
<tr>
<td>CFO</td>
<td>chief financial officer</td>
</tr>
<tr>
<td>CFR</td>
<td>Code of Federal Regulations</td>
</tr>
<tr>
<td>CIRA</td>
<td>common interest realty association</td>
</tr>
<tr>
<td>CIV</td>
<td>collateralized investment vehicle</td>
</tr>
<tr>
<td>CLO</td>
<td>collateralized loan obligation (entity)</td>
</tr>
<tr>
<td>CMV</td>
<td>collateralized manager vehicle</td>
</tr>
<tr>
<td>CP</td>
<td>commercial paper</td>
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<tr>
<td>EITF</td>
<td>Emerging Issues Task Force</td>
</tr>
<tr>
<td>EPC</td>
<td>engineering, procurement, and construction</td>
</tr>
<tr>
<td>ESOP</td>
<td>employee stock ownership plan</td>
</tr>
<tr>
<td>FASB</td>
<td>Financial Accounting Standards Board</td>
</tr>
<tr>
<td>FSP</td>
<td>FASB Staff Position</td>
</tr>
<tr>
<td>FDA</td>
<td>Food and Drug Administration</td>
</tr>
<tr>
<td>FIFO</td>
<td>first in, first out</td>
</tr>
<tr>
<td>FIN</td>
<td>FASB Interpretation Number</td>
</tr>
<tr>
<td>FRM</td>
<td>SEC's Division of Corporation Finance Financial Reporting Manual</td>
</tr>
<tr>
<td>GAAP</td>
<td>generally accepted accounting principles</td>
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<td>GASB</td>
<td>Government Accounting Standards Board</td>
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<tr>
<td>HTM</td>
<td>held to maturity</td>
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<tr>
<td>IAS</td>
<td>International Accounting Standard</td>
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<tr>
<td>IASB</td>
<td>International Accounting Standards Board</td>
</tr>
<tr>
<td>ICFR</td>
<td>internal control over financial reporting</td>
</tr>
<tr>
<td>IFRS</td>
<td>International Financial Reporting Standard</td>
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<tr>
<td>IM</td>
<td>investment management</td>
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<tr>
<td>IRR</td>
<td>internal rate of return</td>
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<tr>
<td>LIBOR</td>
<td>London Interbank Offered Rate</td>
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<tr>
<td>LIFO</td>
<td>last in, first out</td>
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<tr>
<td>LIHTC</td>
<td>low-income housing tax credit</td>
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<tr>
<td>LLC</td>
<td>limited liability company</td>
</tr>
<tr>
<td>MBS</td>
<td>mortgage-backed security</td>
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<tr>
<td>MD&amp;A</td>
<td>Management’s Discussion and Analysis</td>
</tr>
<tr>
<td>Abbreviation</td>
<td>Description</td>
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<tr>
<td>--------------</td>
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<tr>
<td>NFP</td>
<td>not-for-profit (entity)</td>
</tr>
<tr>
<td>O&amp;M</td>
<td>operation and management</td>
</tr>
<tr>
<td>OCA</td>
<td>SEC's Office of the Chief Accountant</td>
</tr>
<tr>
<td>PAC</td>
<td>political action committee</td>
</tr>
<tr>
<td>P&amp;U</td>
<td>power and utilities</td>
</tr>
<tr>
<td>PCAOB</td>
<td>Public Company Accounting Oversight Board</td>
</tr>
<tr>
<td>PCC</td>
<td>Private Company Council</td>
</tr>
<tr>
<td>PPA</td>
<td>power purchase agreement</td>
</tr>
<tr>
<td>PSA</td>
<td>purchase and sale arrangement</td>
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<td>REC</td>
<td>renewable energy credit</td>
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<td>REIT</td>
<td>real estate investment trust</td>
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<tr>
<td>re-REMIC</td>
<td>resecuritization of real estate mortgage investment conduit securities</td>
</tr>
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<td>SAB</td>
<td>SEC Staff Accounting Bulletin</td>
</tr>
<tr>
<td>SEC</td>
<td>Securities and Exchange Commission</td>
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<tr>
<td>SFAS</td>
<td>Statement of Financial Accounting Standards</td>
</tr>
<tr>
<td>SIFMA</td>
<td>Securities Industry and Financial Markets Association</td>
</tr>
<tr>
<td>SOP</td>
<td>AICPA Statement of Position</td>
</tr>
<tr>
<td>SPE</td>
<td>special-purpose entity</td>
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<tr>
<td>UPREIT</td>
<td>umbrella partnership real estate investment trust</td>
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<tr>
<td>VIE</td>
<td>variable interest entity</td>
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</tbody>
</table>
Appendix J — Changes Made in the 2020 Edition of This Publication

The table below summarizes the substantive changes made to this Roadmap since the issuance of last year’s edition as a result of FASB and SEC activity and practice developments.

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<tr>
<th>Section</th>
<th>Title</th>
<th>Description</th>
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</thead>
<tbody>
<tr>
<td>1.3</td>
<td>The Voting Interest Entity Model</td>
<td>Updated to reflect adoption of ASU 2015-02 by all entities.</td>
</tr>
<tr>
<td>3.2</td>
<td>Legal Entities</td>
<td>Added discussion of collaborative arrangements.</td>
</tr>
<tr>
<td>3.2.2</td>
<td>Multitiered Legal-Entity Structures</td>
<td>Updated Example 3-3 to reflect adoption of ASU 2017-01 by all entities.</td>
</tr>
<tr>
<td>3.3.1</td>
<td>Scope Exception for Employee Benefit Plans</td>
<td>Added discussions of ESOPs and rabbi trusts.</td>
</tr>
<tr>
<td>3.4.4.2</td>
<td>Definition of a Business</td>
<td>Updated discussion to reflect adoption of ASU 2017-01 by all entities.</td>
</tr>
<tr>
<td>3.4.4.3</td>
<td>Whether a Development-Stage Entity Is a Business</td>
<td>Deleted section to reflect adoption of ASU 2017-01 by all entities.</td>
</tr>
<tr>
<td>3.4.4.11</td>
<td>Single-Lessee Leasing Activities</td>
<td>Updated Examples 3-30, 3-31, and 3-33 to reflect adoption of ASU 2017-01 by all entities.</td>
</tr>
<tr>
<td>4.2.1.1.2</td>
<td>Interest Rate Variability</td>
<td>Added discussion of the interrelationship between interest rate risk and prepayment risk.</td>
</tr>
<tr>
<td>4.2.1.2.3.1</td>
<td>Subordinated Financial Support</td>
<td>Added factors to consider in the determination of whether a nonrated instrument possesses the characteristics of investment-grade debt.</td>
</tr>
<tr>
<td>4.2.1.2.3.2</td>
<td>Evaluation of Substantiveness of Subordination</td>
<td>Added factors to consider in the determination of whether subordination is substantive.</td>
</tr>
<tr>
<td>Table 4-1</td>
<td>Examples of Variable Interests</td>
<td>Added license and royalty arrangements as examples of variable interests.</td>
</tr>
<tr>
<td>4.3.10.2</td>
<td>Determining Whether an Implicit Guarantee (Variable Interest) Exists</td>
<td>Clarified guidance on when the relationship between related parties may result in the existence of an implicit guarantee and amended Example 4-15.</td>
</tr>
<tr>
<td>4.4.1</td>
<td>“Commensurate” and “At-Market” Fees</td>
<td>Added discussion of the effect of a decision maker’s fee waiver on whether the fee may still be considered commensurate and at-market.</td>
</tr>
<tr>
<td>Section</td>
<td>Title</td>
<td>Description</td>
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<tr>
<td>4.4.1.1</td>
<td>Compensation Received Related to Risk Exposure</td>
<td>Added discussion of whether the expected magnitude of loss that could be incurred in a fee arrangement affects the primary-beneficiary evaluation. Added Example 4-26A.</td>
</tr>
<tr>
<td>Table 5-1</td>
<td>Analysis of Equity Interests</td>
<td>Refined our interpretative view related to the effect of purchased fixed-price put options on a reporting entity's equity interest in a potential VIE and whether the equity interest qualifies as an equity at risk.</td>
</tr>
<tr>
<td>5.2.3</td>
<td>Determining Whether the Identified Equity Investment at Risk Is Sufficient to Finance the Legal Entity's Operations Without Additional Subordinated Financial Support (Step 3)</td>
<td>Clarified guidance on the treatment of components of other comprehensive income in the performance of a quantitative analysis of the sufficiency of equity at risk. Added Examples 5-11A and 5-11B to illustrate considerations related to the design of an entity in the evaluation of whether equity investment at risk is sufficient.</td>
</tr>
<tr>
<td>5.3.1.2.2</td>
<td>Evaluating Kick-Out Rights</td>
<td>Clarified guidance in Example 5-30 on the assessment of whether, in the determination of whether kick-out rights are substantive, the smallest possible combination of limited partner interests that constitutes a simple majority can remove the general partner.</td>
</tr>
<tr>
<td>6.2.2</td>
<td>Determining Whether a Host Entity is a VIE</td>
<td>Updated to reflect adoption of ASU 2015-02 by all entities.</td>
</tr>
<tr>
<td>7.2.4</td>
<td>Which Party, if Any, Has the Power (Step 3) — General Considerations</td>
<td>Added discussion of SEC staff member speech on the determination of the primary beneficiary in circumstances in which a VIE had multiple activities that affected the entity's economic performance.</td>
</tr>
<tr>
<td>7.2.7.1</td>
<td>Shared Power</td>
<td>Added discussion of how processes for resolving disagreements may affect the assessment of shared power.</td>
</tr>
<tr>
<td>7.2.7.2</td>
<td>Multiple Parties Performing the Same or Different Significant Activities</td>
<td>Added discussion of the assessment of ASC 810-10-25-38E in the context of related-party groups.</td>
</tr>
<tr>
<td>7.3.5.1</td>
<td>Consideration of Interests Held by Entities Under Common Control</td>
<td>Updated Example 7-18 to apply before and after the adoption of ASU 2018-17.</td>
</tr>
<tr>
<td>8.2.3.2</td>
<td>Interests Received as a Loan or Contribution</td>
<td>Refined our interpretative view related to the effect of purchased fixed-price put options on a reporting entity's equity interest in a potential VIE and whether the equity interest qualifies as an equity at risk.</td>
</tr>
<tr>
<td>8.2.3.4</td>
<td>Transfer Restrictions</td>
<td>Updated discussion of the evaluation of whether transfer restrictions may result in a de facto agency relationship.</td>
</tr>
<tr>
<td>Section</td>
<td>Title</td>
<td>Description</td>
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</tr>
<tr>
<td>9.1.4</td>
<td>Additional Equity Investment at Risk or Modification/Curtailment of Activities</td>
<td>Added Example 9-6A.</td>
</tr>
<tr>
<td>11.1.3.3</td>
<td>Elimination of a Reporting Lag Between Parent and Subsidiary</td>
<td>Removed obsolete requirements as a result of the SEC’s final rule that updates and simplifies disclosures.</td>
</tr>
<tr>
<td>11.1.4.4</td>
<td>Presentation of a Parent Company’s Interest in a VIE When the VIE and Primary Beneficiary of the VIE Are Under Common Control</td>
<td>Simplified the discussion of presentation in circumstances in which the primary beneficiary of a VIE and the VIE are under common control and a cross-reference to Section 3.1.1 of Deloitte’s A Roadmap to Accounting for Noncontrolling Interests.</td>
</tr>
<tr>
<td>11.2.5.3</td>
<td>Disclosure Requirements for Private-Company Alternative</td>
<td>Added section on required disclosures under the private-company alternative.</td>
</tr>
<tr>
<td>D.1.7</td>
<td>Reassessment of Controlling Rights</td>
<td>Added section that discusses when controlling rights should be reassessed under the voting interest entity model.</td>
</tr>
<tr>
<td>D.2.3.2</td>
<td>Noncontrolling Approval or Veto Rights Qualified by the Phrase “Other Than in the Ordinary Course of Business”</td>
<td>Added factors to consider in the assessment of noncontrolling approval or veto rights qualified by the phrase “other than in the ordinary course of business” and other similar phrases. Also added Example D-6D to illustrate the above.</td>
</tr>
<tr>
<td>D.2.3.3</td>
<td>Noncontrolling Rights to Block Acquisitions and Dispositions of Assets</td>
<td>Updated Example D-7 to clarify details of the scenario and accounting analysis.</td>
</tr>
<tr>
<td>D.3.2</td>
<td>Subsidiaries Operating Under Foreign Exchange Restrictions and Other Uncertainties</td>
<td>Reorganized section to clarify and update discussion of consolidation presumptions related to lack of currency exchangeability.</td>
</tr>
<tr>
<td>E.2</td>
<td>Collateralized Investment Vehicles</td>
<td>Renamed section from “Collateralized Financing Entities” and updated discussion to clarify the scope of entities being discussed therein.</td>
</tr>
<tr>
<td>E.5.5.1</td>
<td>Deconsolidation and Change in Ownership (Noncontrolling Interest Transactions)</td>
<td>Updated section to reflect the impact of the adoption of ASC 606 and ASC 842.</td>
</tr>
<tr>
<td>F.2.1.2</td>
<td>Nonfinancial Assets</td>
<td>Added flowchart to illustrate considerations related to the application of ASC 606, ASC 810-10, ASC 860, ASC 610-20, or other U.S. GAAP to the transfer of a nonfinancial asset.</td>
</tr>
<tr>
<td>F.4.1</td>
<td>SEC Reporting Requirements Upon Deconsolidation of a Subsidiary</td>
<td>Added flowchart to illustrate considerations related to the reporting obligations a registrant could have under Form 8-K, Item 2.01, when it completes a disposition.</td>
</tr>
</tbody>
</table>