Consolidation
A Roadmap to Identifying a Controlling Financial Interest

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Preface

December 10, 2015

To the clients, friends, and people of Deloitte:

We are pleased to present Consolidation — A Roadmap to Identifying a Controlling Financial Interest, the newest addition to Deloitte’s Roadmap series. This publication reflects changes in the consolidation landscape that have taken place since we issued our previous Roadmap on the consolidation of variable interest entities (VIEs\(^1\)), most notably the FASB’s issuance of ASU 2015-02\(^2\) earlier this year.

While the changes to the consolidation guidance were not unexpected, there have been numerous twists in their development. After working together on a joint project to establish a single consolidation model, the FASB and IASB ultimately decided not to converge their guidance and instead followed their own paths. The IASB amended its consolidation model in May 2011 with the issuance of IFRS 10, and after deciding not to rewrite its consolidation guidance, the FASB issued ASU 2015-02 in February 2015 to make targeted amendments to its consolidation model. Although the ASU’s amendments were intended to address concerns that primarily apply to the investment management sector, the ASU could have a significant effect on the consolidation conclusions for entities in all industries.

While ASU 2015-02 is not yet effective for all companies (generally, it is effective in 2016 for public entities and 2017 for private entities, with early adoption permitted), the guidance in this Roadmap is written as if adoption has occurred. Notwithstanding this focus, many of the concepts underlying the identification of a controlling financial interest have remained the same. Accordingly, this Roadmap highlights the significant changes that resulted from the issuance of ASU 2015-02 and describes the purpose and effects of the ASU’s changes. Further, the Roadmap’s Appendix A and Appendix B compare ASU 2015-02 with the predecessor consolidation models in ASU 2009-17 and FIN 46(R).

In addition, while the Roadmap’s focus is on the complexities of identifying whether a legal entity is a VIE and whether a reporting entity should consolidate a VIE, Appendix D provides a framework and our interpretations of how a reporting entity should apply the voting interest entity model.

We understand that this new guidance (like its predecessors) can be complex and difficult to apply. In addition, because there are multiple versions of pending content in the FASB Accounting Standards Codification (the “Codification”) whose application depends on whether a reporting entity has adopted the ASU or whether the investee is evaluated for consolidation in accordance with the predecessor consolidation models in ASU 2009-17 or FIN 46(R), the Codification is very difficult to navigate. The Roadmap therefore breaks down the consolidation requirements and reconstructs them in a logical narrative, making the guidance simpler for novices and even grizzled VIE veterans to understand and apply.

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\(^1\) For a list of abbreviations used in this publication, see Appendix H.
\(^2\) For a list of the titles of standards and other literature referred to in this publication, see Appendix G.
The body of the Roadmap combines the consolidation requirements in ASC 810 with Deloitte’s interpretations and examples in a comprehensive, reader-friendly format. The table of contents contains links to each section, and several sections feature a “thumbnail” that, when clicked, links to a flowchart with each step of the consolidation analysis. If you are ever lost, we recommend grounding yourself by going back to the flowchart (at the end of the Introduction) and determining why the step you are on is relevant. Believe us, it is easy to lose your way.

Although the ASU is final, the implementation efforts have just begun, and we are continuing to receive questions about its application and requirements. We encourage you to use this Roadmap as a guide throughout your implementation of the ASU and to contact us with any questions or suggestions for future improvements. We hope that you find this publication a valuable resource as we enter this new chapter in the consolidation story. Finally, although this Roadmap is intended to be a helpful resource, it is not a substitute for consulting with Deloitte professionals on complex accounting questions and transactions.

Deloitte & Touche LLP
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Introduction

The Evolution Story

After more than four decades of little change, the accounting guidance on consolidation has been evolving rapidly over the past 15 years. 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)

In 1959, the FASB issued ARB 51, which 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 past 25 years and in January 2003 created the VIE model to address these concerns.

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.

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.

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 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 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 is not a VIE. However, if the limited partners hold substantive kick-out or participating rights, this presumption could be overcome. Although EITF 04-5 (codified in ASC 810-20) has been 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 FIN 46(R) and EITF 04-5)**

ASU 2015-02 is the latest chapter in the consolidation evolution story. While the ASU did not introduce any new models, its changes eliminated two of the existing models (FIN 46(R) and 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) has been eliminated, thereby removing the risks-and-rewards-based consolidation model under FIN 46(R) from U.S. GAAP.
- The limited partnership model in ASC 810-20 has been eliminated. Instead, limited partnerships will be VIEs unless the limited partners have substantive kick-out or participating rights. Although more limited partnerships will be 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 has been amended. Specifically, it is less likely that the fees themselves would be considered a variable interest, that a legal entity would be a VIE, or that a decision maker would consolidate the legal entity.
- The ASU significantly amends how variable interests held by a reporting entity’s related parties or de facto agents affect its consolidation conclusion. In addition, the ASU will result in less frequent performance of the related-party tiebreaker test (and mandatory consolidation by one of the related parties) than under the previous VIE models.

As noted in the Preface, although ASU 2015-02 is not yet effective for all companies (generally, it is effective in 2016 for public entities and in 2017 for private entities, with early adoption permitted), the guidance in this Roadmap is written as if adoption has already occurred.

**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, or FASB priorities or some combination thereof prompt further changes to address the future environment? Over the years, many of the amendments were designed to identify the appropriate consolidation framework for different types of legal entities. In the 1990s, the EITF made several attempts to define a special-purpose entity (SPE). For the last 12 years, practitioners have been applying the complex guidance on identifying a VIE. Although convergence has yet to be achieved, a single model under which a controlling financial interest can be determined regardless of whether a legal entity is a VIE would simplify the analysis (and this Roadmap). If history tells us anything, this will not be the last chapter.

**Consolidation Decision Trees**

ASC 810-10-05-6 contains a flowchart\(^1\) 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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\(^1\) 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.”
**Introduction**

Is the entity being evaluated for consolidation a legal entity? (Section 3.2)

- Yes
  - Stop consolidation analysis.*

- No
  - Does a scope exception from 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? (Section 4)
            - Yes
              - No
              - Is the legal entity a VIE? (Section 5)
                - Yes
                  - Evaluate under voting interest entity model.
                - No
                  - Evaluate under VIE model.

Does the reporting entity have power and significant economic exposure (through its direct and indirect interests)? (Sections 7.2 and 7.3)

- Yes
  - Reporting entity consolidates the VIE.
- No
  - Does the reporting entity share power with a related party and does the related-party group have 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
      - Related parties under common control have power and significant economic exposure? (Section 7.4.2.3)
        - Yes
          - That single variable interest holder in the related-party group consolidates the VIE.
          - Yes
            - No
            - Stop consolidation analysis.*
          - No
            - Consolidate the legal entity.
        - 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
              - No
              - Stop consolidation analysis.*
            - No
              - Stop consolidation analysis.*

* Consolidation is not required; however, other GAAP may be relevant to determine 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.
Section 1 — Overview of the Consolidation Models

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 variable interest entity model. Both accounting models require the reporting entity\(^1\) to identify whether it has a “controlling financial interest” in a legal entity\(^2\) 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.

ASU 2015-02 retains the two primary consolidation models (eliminating the multiple VIE models) and modifies the limited partnership–specific requirements previously in ASC 810-20 by eliminating ASC 810-20 and incorporating the concepts from ASC 810-20 into the VIE decision tree in ASC 810-10.

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 to the right 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 scope exception, would the reporting entity apply the voting interest entity model or other applicable GAAP.

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1 Throughout this Roadmap, “reporting entity” refers to the party performing the consolidation analysis (i.e., the party potentially consolidating a legal entity).

2 Throughout this Roadmap, “legal entity” refers to the entity that is analyzed for potential consolidation.
1.1.2 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.

1.1.3 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.

1.1.4 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) 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 Section 4 for further discussion of variable interests.

If a reporting entity holds a variable interest, the reporting entity must continue its consolidation analysis.

1.1.5 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 Section 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 Section 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. Before the issuance of ASU 2015-02, the voting interest entity model was codified in the guidance on consolidation of (1) corporations in ASC 810-10 and (2) limited partnerships (and similar entities) in ASC 810-20. ASU 2015-02 eliminated the specific consolidation guidance on limited partnerships in ASC 810-20, and now 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 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. Before ASU 2015-02’s amendments to ASC 810, the general partner of a limited partnership was presumed to control the limited partnership under the voting interest entity model and was required to consolidate the limited partnership unless the limited partners had either (1) the substantive ability to dissolve (liquidate) the limited partnership or otherwise remove the general partner without cause or (2) substantive participating rights. However, under ASC 810-10 as amended by ASU 2015-02, 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

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.

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>
<tbody>
<tr>
<td>Definition of a controlling financial interest</td>
<td>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.</td>
<td>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.</td>
</tr>
<tr>
<td>Impact of related parties</td>
<td>Related parties and de facto agents are not considered.</td>
<td>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.</td>
</tr>
<tr>
<td>Participating rights — definition</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. 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 any decision that allows it to effectively participate in certain significant financial and operating decisions that occur as part of the ordinary course of the investee’s business. 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>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 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 all of the activities that most significantly affect the economic performance of the VIE.</td>
</tr>
<tr>
<td>Forward starting rights and potential voting rights</td>
<td>Only existing voting rights are considered in the analysis of which party has a controlling financial interest. 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>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>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>
1.5 Comparison With IFRSs

Under IFRSs, 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. The different requirements may result in different consolidation conclusions, although frequently the same reporting entity would consolidate a legal entity under both U.S. GAAP and IFRSs. Most notably, IFRS 10 contains a single, control-based model for determining consolidation of a legal entity. In other words, IFRS 10 does not require an analysis of whether a legal entity is a VIE or voting interest entity, which adds complexity to the analysis under U.S. GAAP.

Table 1-2 below summarizes the primary differences between U.S. GAAP and IFRSs in the determination of whether to consolidate a legal entity.3

<table>
<thead>
<tr>
<th>Subject</th>
<th>U.S. GAAP</th>
<th>IFRSs</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Scope exceptions</strong></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 (1) employee benefit plans, (2) investment companies, (3) governmental entities, and (4) certain money market funds. In addition, there are certain VIE scope exceptions.</td>
<td>IFRS 10 provides a general scope exception for (1) postemployment benefit plans or other long-term employee benefit plans and (2) an investment entity that is required to measure all of its subsidiaries at fair value through profit or loss. IFRS 10, as discussed below, does not have a separate VIE model; therefore, those additional scope exceptions are not applicable. A parent is also exempt from consolidation if it is a nonlisted parent that is itself a wholly owned subsidiary of a parent that prepares financial statements under IFRSs that are publicly available (or a partially owned subsidiary of such a parent, and none of its other owners have objected). The financial statements of the entity’s ultimate or immediate parent should include the subsidiaries of that parent either by consolidation or by measurement at fair value through profit or loss.</td>
</tr>
<tr>
<td><strong>Determining when to consolidate a legal entity</strong></td>
<td>There are two models for determining when consolidation is appropriate (the VIE and voting interest entity models).</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 only if the relevant activities of an investee are directed through voting rights.</td>
</tr>
<tr>
<td><strong>Definition of control — general principle</strong></td>
<td>Under the voting interest entity model, a controlling financial interest is defined as “ownership of a majority voting interest” 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. 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>Under IFRS 10, 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 when assessing whether it controls the investee. This principle is similar to the U.S. GAAP control analysis under the VIE model. However, several differences exist, including the analysis of potential voting rights, de facto power, and the effects of agency relationships.</td>
</tr>
</tbody>
</table>

3 Differences are based on a comparison of authoritative literature under U.S. GAAP and IFRSs and do not necessarily include interpretations of such literature.
### Table 1-2 — Determining Whether to Consolidate a Legal Entity — Differences Between U.S. GAAP and IFRSs (continued)

<table>
<thead>
<tr>
<th>Subject</th>
<th>U.S. GAAP</th>
<th>IFRSs</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Control analysis — shared power</strong></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>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. Each investor would account for its interest in the investee in accordance with the relevant IFRS, such as IFRS 11, IAS 28, or IFRS 9.</td>
</tr>
<tr>
<td><strong>Control analysis — potential voting rights</strong></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, instruments convertible into voting shares) when determining whether a controlling financial interest exists. For example, under the voting interest 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, careful consideration is required (see Section 7.2.9).</td>
<td>IFRS 10 requires potential voting rights, such as those arising from convertible instruments or options, to be taken into account 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 would be considered when they are “substantive” (i.e., capable of giving the investor the current ability to direct the investee’s relevant activities). IFRS 10 provides guidance on determining whether rights are substantive.</td>
</tr>
<tr>
<td><strong>Control analysis — de facto power</strong></td>
<td>This concept does not exist under U.S. GAAP.</td>
<td>Even when an investor with less than a majority of voting rights has not entered into additional contractual arrangements, it may still have power over the legal entity if its voting rights give it “the practical ability to direct the relevant activities unilaterally” (paragraph B41 of IFRS 10). This circumstance may arise when the investor’s holdings of voting rights are significantly more 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.</td>
</tr>
<tr>
<td><strong>Control analysis — related parties and agency relationships</strong></td>
<td>The voting interest entity model does not have prescriptive related-party rules in the determination of 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 power over the VIE.</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 related parties are less likely to result in consolidation 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.</td>
</tr>
</tbody>
</table>
### Table 1-2 — Determining Whether to Consolidate a Legal Entity — Differences Between U.S. GAAP and IFRSs (continued)

<table>
<thead>
<tr>
<th>Subject</th>
<th>U.S. GAAP</th>
<th>IFRSs</th>
</tr>
</thead>
<tbody>
<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>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 less than three months, 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>A parent is prohibited from consolidating a subsidiary with a different reporting period unless it is impractical to align the reporting period. If it is impractical for a subsidiary to have the same reporting period as its parent, the difference 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 IFRSs.</td>
</tr>
</tbody>
</table>
Section 2 — Glossary of Selected Terms

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 section 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

**ASC 810-10**

**Objectives — General**

10-1 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.

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 Section 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 Section 7 for guidance on how a reporting entity should assess whether it has a controlling financial interest in a VIE.

2.2 Decision Maker

**ASC 810-10-20**

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.
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). 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.

Paragraph BC76 in the Basis for Conclusions of ASU 2015-02 states that if certain criteria 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

<table>
<thead>
<tr>
<th>ASC 810-10-20</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Expected Losses</strong></td>
</tr>
<tr>
<td>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.</td>
</tr>
<tr>
<td><strong>Expected Residual Returns</strong></td>
</tr>
<tr>
<td>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.</td>
</tr>
<tr>
<td><strong>Expected Losses and Expected Residual Returns</strong></td>
</tr>
<tr>
<td>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).</td>
</tr>
<tr>
<td><strong>Expected Variability</strong></td>
</tr>
<tr>
<td>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.</td>
</tr>
</tbody>
</table>

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 810-10-20</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>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>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) or (2) other than a limited partnership (or similar entity). 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

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

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 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 810-10-20**

**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:

- 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.
- 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.
- 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.

**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:

- Amendments to articles of incorporation or partnership agreements of the investee
- 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
- 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

**ASC 810-10-20**

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.

A reporting entity that consolidates (i.e., has a controlling financial interest in) a VIE is the “primary beneficiary” of the VIE. See Section 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

**ASC 810-10-20**

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.

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 (see Section 3.5 for details).

### 2.10 Public Business Entity

**ASC 810-10-20**

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.

- 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).
- 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.
- 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.
- 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.
- 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 footnotes) 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.

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 2015-02 (see Section 12.1), and whether a reporting entity can elect to apply ASU 2014-07 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 and De Facto Agents

ASC 810-10-20

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.

ASC 810-10-25-43

De Facto Agents
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 Section 8 for more details.
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

**ASC 810-10-20**

Variable interests that will absorb some or all of a variable interest entity’s (VIE’s) expected losses.

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).
- 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

**ASC 810-10-20**

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.

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 Section 4 for additional details.
2.15 Variable Interest Entity

A legal entity subject to consolidation according to the provisions of the Variable Interest Entities Subsections of Subtopic 810-10.

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 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 Section 3 for guidance on scope exceptions, and see Section 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

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).

A 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. Common examples of CFEs are collateralized loan obligation entities (CLOs) and collateralized debt obligation entities (CDOs). These entities are typically VIEs because their capital structure qualitatively indicates there is insufficient equity investment at risk. See Section E.2 for consolidation considerations of a CFE. In addition, some reporting entities that consolidate a CFE elect to carry all of the financial assets and financial liabilities at fair value. The FASB provided a measurement alternative for consolidated CFEs (see Sections 10.1.3 and 10.2.2).
Section 3 — Scope

3.1 Introduction

ASC 810-10

15-3 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.
**Section 3 — Scope**

**ASC 810-10 (continued)**

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.

15-4 All legal entities are subject to this Topic’s evaluation guidance for consolidation by a reporting entity, with specific qualifications and exceptions noted below.

15-5 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.

15-6 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 from the VIE model. The voting interest model in ASC 810-10 is applied only if it is determined that the legal entity qualifies for a VIE scope exception or the legal entity is not subject to the VIE subsections of ASC 810-10. Evaluating whether a legal entity qualifies for a scope exception or is subject to the VIE subsections of ASC 810-10 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 section 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. Section 5 provides guidance on whether a legal entity is subject to the VIE subsections of ASC 810-10 (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 subsections of ASC 810-10. Accordingly, application of the VIE model in ASC 810-10 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 of ASC 810-10. 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 of ASC 810-10, or does not meet the definition of a VIE, would consolidation of the legal entity be evaluated under the voting interest model in ASC 810-10.

### 3.2 Legal Entities

**ASC 810-10-20**

**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.

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.

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1 While ASC 810-10 primarily focuses on the voting interest entity model and the VIE model, it also discusses the consolidation of entities that are controlled by contract. Although the guidance in the ASC 810-10 subsections on the consolidation of contract-controlled entities applies to all entities (except those that are deemed VIEs), the context of that guidance is physician practice management entities. See Section D.3.4 for discussion of the contract-controlled entity model.
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?

Paragraph BC38 in the Basis for Conclusions 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

**ASC 810-10**

15-15 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.

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).
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 silo\(^2\)) 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 new 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.

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 the Basis for Conclusions of ASU 2015-02 (see the introduction to Section 3.2 above).

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 legal 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.

### 3.2.2 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 become those of the parent company upon consolidation.

When a reporting entity applies the VIE model in ASC 810-10 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.

\(^2\) See Section 6 for a discussion of silos.
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). In determining whether 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 entity 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.

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 only asset is a building that is leased to the investor.

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 entity 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 a single-lessee leasing arrangement with one of the investors, which is a scenario in which the business scope exception cannot be applied (see ASC 810-10-15-17(d)(4)).

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 a holding company that is not a joint venture. The holding company was designed for the sole purpose of acquiring 100 percent of the ownership interests in an existing business (as defined in ASC 805). The investor was involved in the design of the holding company but was not involved in either the design or redesign of the business. Assume that the investor, the existing business, and the holding company do not meet any of the other business scope exception conditions. If the investor can look through the holding company to the underlying legal entity, it can apply the business scope exception. If the investor cannot look through the holding company, it cannot apply the business scope exception because the investor was involved in the design of the holding company (see ASC 810-10-15-17(d)(1)).

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 reporting entity 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 3-4

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 so, the business scope exception cannot be applied.
Example 3-5

Assume the same facts as in Example 3-4, 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 because the holding company’s loan precludes the investor from looking through the holding company to the underlying legal entity.

Example 3-6

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.

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

15-12 The guidance in this Topic does not apply in any of the following circumstances:

- An employer shall not consolidate an employee benefit plan subject to the provisions of Topic 712 or 715.
- Subparagraph superseded by Accounting Standards Update No. 2009-16
- Subparagraph superseded by Accounting Standards Update No. 2009-16
- 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.
- 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.
- 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. 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), the consolidation requirements in ASC 810-10 would not apply to other employee benefit plans.

3.3.2 Scope Exception for Investment Companies

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

Note that this scope exception 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, it 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 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 3-7

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 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 3-8

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; X must therefore consider whether it is required to consolidate Y under the VIE model in 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 investments 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 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. SEC Regulation S-X, Rule 6-03(c)(1), states that consolidated financial statements of a registered investment company may include only “subsidiaries which are investment companies.” However, Regulation S-X contains no additional guidance on when an 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 entities. Other entities 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/position reverting to a government [without compensation by that government]

• The power to enact and enforce a tax levy

Furthermore, entities 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, entities 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 3-9**

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 3-10**

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.
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 the Basis for Conclusions 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

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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. 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 in ASC 810-10 (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 in ASC 810-10, 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 Section 8). See Section 3.4.1.3 for additional guidance on the consolidation model for NFPs.

3.4.1.1 Whether Entities That Present Their Financial Statements in a Manner Similar to an NFP Can Qualify for the NFP Scope Exception

The Codification Master Glossary defines a not-for-profit entity as an “entity that possesses the following characteristics, in varying degrees, that distinguish it from a business entity:

a. Contributions of significant amounts of resources from resource providers who do not expect commensurate or proportionate pecuniary return

b. Operating purposes other than to provide goods or services at a profit

c. Absence of ownership interests like those of business entities.”

Only entities that meet the Codification’s definition of an NFP can qualify for the not-for-profit scope exception in ASC 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 not-for-profit scope exception.
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. If the CIRA entity is not a VIE, A is not required to apply the VIE model to that entity, even though the CIRA does not meet the not-for-profit scope exception.

### 3.4.1.2 Use of 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 in ASC 810-10, the NFP is subject to the VIE model in ASC 810-10. The determination of whether an NFP has been established to circumvent the VIE model in ASC 810-10 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 3-12

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, Enterprise A cannot use the not-for-profit 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 in ASC 810-10. 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.

### 3.4.1.4 Retention of a For-Profit Reporting Entity’s Accounting Policies in the Consolidated Financial Statements of a Not-for-Profit Reporting Entity

For-profit reporting entities that are owned by not-for-profit 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 not-for-profit reporting entity. This position is supported by analogy to ASC 810-10-25-15, which states, in part:

[The application of guidance in an industry-specific Topic of this Codification to a subsidiary within the scope of that industry-specific Topic shall be retained in consolidation of that subsidiary.]

### Example 3-13

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 NFPs 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 in ASC 810-10 to a separate account of the life insurance company. However, a separate account must nevertheless apply the VIE model in ASC 810-10 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 addressed, 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 indicates 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 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. 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 in ASC 810-10 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 Annual 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:

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.
- 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)).

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):
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• 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 3-14

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 Entity 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 would be outside the scope of the VIE model because it did not provide more than half the support. However, Enterprise 1 must analyze its interest under the VIE model because it provided more than half the total subordinated support to the joint venture.

3.4.4.2 Definition of a Business

ASC 805-10-20 defines a business as follows:

An 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 a business consists of.

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 Whether a Development-Stage Entity Is a Business

ASC 805 provides that a “business consists of inputs and processes applied to those inputs that have the ability to create outputs” and that a business “requires two essential elements — inputs and processes applied to those inputs, which together are or will be used to create outputs.” A development-stage entity that is not yet producing outputs may be considered a business in accordance with ASC 805. ASC 805-10-55-7 provides a list of factors to consider to determine whether an entity in the development stage meets the definition of a business.

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 Section 9), and (3) as of each reporting date (see note below). 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 Section 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:

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]

### Example 3-15

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. Therefore, 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 3-16

Assume the same facts as in Example 3-15 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. This event changes the design of the joint venture (i.e., the design was to pay off the debt after 20 years). 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 de facto agents as described in 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:
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• 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 3-17

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 3-18

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 810-10-15-43(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 franchise. Therefore, investors in a joint venture under joint control may participate in the design or redesign of a legal entity and still qualify for the business scope exception (assuming the other conditions that prohibit application of the exception are not met).

Because authoritative accounting literature provides little guidance on the definition of a joint venture or joint control, a reporting entity must determine whether a legal entity is a joint venture under joint control on the basis of facts and circumstances. The most significant characteristic that distinguishes a joint venture from other forms of entities is the owners’ joint control over the significant operating decisions of a legal entity. Below are several references in authoritative accounting literature to joint venture arrangements and joint control. A reporting entity should consider them in analyzing whether a legal entity is a joint venture.

The Codification Master Glossary defines a corporate joint venture as:

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.

In a speech at the 1993 AICPA Conference on Current SEC Developments, the SEC staff discussed certain indicators of whether any of the joint venturers individually control a legal entity:

An agreement between the venturers that requires consent of both venture parties for typical corporate actions generally indicates that control is not present as to either venturer. If the majority holder cannot order the sale of assets in the ordinary course of business without the consent of its joint venture partner, the staff believes control is not present. However, if the joint venture agreement requires the consent of both parties only in the case of a disposition of substantially all assets (an action that is clearly not in the ordinary course of business), the staff would not conclude that provision would negate the other aspects of control.

Further, the AcSEC indicated in its advisory conclusion in the July 17, 1979, 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 Committee also recommended that the definition from Section 3055 of the CICA Handbook be adopted in substance as the definition of a joint venture. This definition states:

A joint venture is 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.

While not considered to constitute GAAP, the G4+1 Organization Special Report Reporting Interests in Joint Ventures and Similar Arrangements may be helpful in the determination of joint control. Paragraph 2.14 of the Special Report states:

Joint control — Joint control over an enterprise exists when no one party alone has the power to control its strategic operating, investing, and financing decisions, but two or more parties together can do so, and each of the parties sharing control (joint venturers) must consent.

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 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.
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- 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 3-19

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 3-20

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 3-21

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 3-22

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, C (unlike in Example 3-21) does not appear to be an extension of A’s business, even though A provides all of C’s raw materials. 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 3-23

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 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 3-24

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 de facto agents as described in ASC 810-10-25-43(d). (See Section 3.4.4.8 for 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.

Example 3-25

Company A contributes $5 million cash in exchange for 50 percent of the equity of Entity X. Other equity holders contribute $3 million in cash to the entity in exchange for the remaining 50 percent of the equity in X, and X raises additional funds via a $2 million note payable to a financial institution that is considered additional subordinated financial support. Company A provides the financial institution with a guarantee of the note payable. The guarantee absorbs expected losses of the entity and is therefore also considered to be additional subordinated financial support. The fair value of the guarantee is determined to be $1 million. 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 ($11 million), A would not be able to avail itself of the business scope exception.

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 following examples 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:
**Example 3-26**

**Put Options**

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.

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 3-27**

**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). 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 lease under ASC 840 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.
Section 3 — Scope

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 that are all part of a related-party group would generally be equivalent to leasing assets to a single lessee.

Example 3-28

Entity A is designed to lease medical equipment to various hospitals and 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 owns various hospitals; the remaining 40 percent 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 equipment (and is actually leasing its equipment) 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 3-29

Enterprise B obtains 100 percent of the equity in Entity A in exchange for a building. At the same time, B leases the building from A. 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 3-30

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 3-31

Entity A owns 10 office buildings. It leases each of these buildings to a different enterprise that is either partially or wholly owned by the same parent, Enterprise X. The governing documents of A do not restrict it from entering into lease contracts with parties other than X and its related-party group, and A was not designed solely to lease office buildings to X. However, even though A’s governing documents allow it to enter into lease contracts with parties outside of X and its related-party group, the actual activities of A involve leasing the office buildings to a single related-party group. Therefore, the individual lease contracts should be viewed as a single-lessee leasing arrangement, and A cannot apply the business scope exception.
3.5 Private-Company Alternative

ASC 810-10

15-17A 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:

a. The private company lessee (the reporting entity) and the lessor legal entity are under common control.

b. The private company lessee has a lease arrangement with the lessor legal entity.

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.

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.

See paragraph 810-10-55-9 and paragraphs 810-10-55-205A through 55-205I 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 810-10-15-17A 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 810-10-15-17A 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.

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.

The FASB developed the alternative to address concerns by private-company stakeholders that the costs and complexity of complying with the VIE model for common control leasing arrangements did not yield meaningful benefits to financial statement users since in many cases common-control lessor entities were established for tax, estate-planning, and legal-liability purposes and were not designed for off-balance-sheet financing purposes. The FASB observed the following in paragraph BC10 of ASU 2014-07’s Basis for Conclusions:

In instances in which a lessor entity is consolidated by a private company lessee entity on the basis of VIE guidance, most users of the private company lessee entity’s financial statements stated that consolidation is not relevant to them because they focus on the cash flows and tangible worth of the standalone private company lessee entity, rather than on the consolidated cash flows and tangible worth of the private company lessee entity as presented under U.S. GAAP. Those users also stated that consolidation of the lessee entity under common control distorts financial statements of the private company lessee entity because the assets held by the lessee entity would not be available to satisfy the obligations of the lessee entity. They indicated that these assets are beyond the reach of the lessee’s creditors, even in bankruptcy or other receivership. Consequently, those users stated that when they receive consolidated financial statements, they often request a consolidating schedule to enable them to reverse the effects of consolidating the lessor entity.

The accounting alternative allows a private company lessee (reporting entity) to elect not to apply the VIE model to a lessor entity if:

1. The “private company lessee and the lessor entity are under common control.”
2. The “private company lessee has a lease arrangement with the lessor entity.”
3. “[S]ubstantially all of the activities between the private company lessee and the lessor entity are related to leasing activities (including supporting leasing activities) between those two entities.”
4. “[I]f the private company lessee explicitly guarantees or provides collateral for any obligation of the lessor 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 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 on leases. ASC 810-10-55-205AJ through 55-205AR provide implementation examples that illustrate the evaluation of whether a private-company lessee qualifies for this accounting alternative. In addition, if the private-company lessee elects this accounting alternative, it would provide additional disclosures about the arrangement, including “(a) the amount and key terms of liabilities recognized by the lessor entity that expose the private company lessee to providing financial support to the lessor entity and (b) a qualitative description of circumstances not recognized in the financial statements of the lessor entity that expose the private company lessee to providing financial support to the lessor entity.”
Section 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 Section 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 Section 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) 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) “[a]nalyze the nature of the
risks in the legal entity” and (2) “[d]etermine 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 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.

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.
### Section 4 — Variable Interests

#### ASC 810-10 (continued)

<table>
<thead>
<tr>
<th>Paragraph</th>
<th>Text</th>
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<tbody>
<tr>
<td>25-27</td>
<td>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.</td>
</tr>
<tr>
<td>25-28</td>
<td>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).</td>
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<tr>
<td>25-29</td>
<td>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.</td>
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<tr>
<td>25-30</td>
<td>The following addresses various considerations related to determination of variability, specifically:</td>
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<tr>
<td></td>
<td>a. Terms of interests issued</td>
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<td>b. Subordination</td>
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<td>c. Certain interest rate risk</td>
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<td>d. Certain derivative instruments.</td>
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#### Terms of Interests Issued

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<th>Paragraph</th>
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<td>25-31</td>
<td>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.</td>
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#### Subordination

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<tr>
<td>25-32</td>
<td>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.</td>
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#### Certain Interest Rate Risk

<table>
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<tr>
<td>25-33</td>
<td>Periodic interest receipts or payments shall be excluded from the variability to consider if the legal entity was not designed to create and pass along the interest rate risk associated with such interest receipts or payments to its interest holders. However, interest rate fluctuations also can result in variations in cash proceeds received upon anticipated sales of fixed-rate investments in an actively managed portfolio or those held in a static pool that, by design, will be required to be sold prior to maturity to satisfy obligations of the legal entity. That variability is strongly indicated as a variability that the legal entity was designed to create and pass along to its interest holders.</td>
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### 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 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 may have foreign currency risk or interest rate risk, but the legal entity may not have been designed to pass on those risks.

#### 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 VIE until maturity, should generally not be considered in the determination of whether an interest is a variable interest.

However, 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.

### 4.2.1.2 Performing Step 2

#### 4.2.1.2.1 Factors to Consider

In performing step 2 of the by-design approach, the reporting entity should consider the following factors:

- The activities of the legal entity.
- The terms of the contracts the legal entity has entered into.
- The nature of the legal entity’s interests issued.
- How the legal entity was marketed to potential investors.
- Which parties participated significantly in the design or redesign of the legal entity.
In addition, ASC 810-10-25-31 through 25-33 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 extent of losses absorbed by an interest, as measured by its absorption in relation to the overall losses by the entity, will determine 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).

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 variable interests constitute subordinated financial support is important in the evaluation of a legal entity for consolidation. For example, ASC 810-10-15-17(d)(3) requires a 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 a 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).

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.

Careful consideration is required in the evaluation of whether a nonrated instrument possesses the characteristics to be considered investment-grade.
Section 4 — 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. In making that assessment, the reporting entity would consider all facts and circumstances. 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 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.

4.3 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.

55-18 For a legal entity that is not a VIE (sometimes called a voting interest entity), all of the legal entity’s assets, liabilities, and other contracts are deemed to create variability, and the equity investment is deemed to be sufficient to absorb the expected amount of that variability. In contrast, VIEs are designed so that some of the entity’s assets, liabilities, and other contracts create variability and some of the entity’s assets, liabilities, and other contracts (as well as its equity at risk) absorb or receive that variability.

55-19 The identification of variable interests involves determining which assets, liabilities, or contracts create the legal entity’s variability and which assets, liabilities, equity, and other contracts absorb or receive that variability. The latter are the legal entity’s variable interests. The labeling of an item as an asset, liability, equity, or as a contractual arrangement does not determine whether that item is a variable interest. It is the role of the item—to absorb or receive the legal entity’s variability—that distinguishes a variable interest. That role, in turn, often depends on the design of the legal entity.

ASC 810-10-20 defines variable interests in a VIE 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 VIE 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 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 3.2 and 3.3, respectively).

• A reporting entity’s variable interest in specified assets of a VIE may not be considered a variable interest in that legal entity (as described in ASC 810-10-25-55 and 25-56). However, the reporting entity’s variable interest may represent an interest in a “siloh,” as described in ASC 810-10-25-57 (see Section 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>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 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. 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 4.3.6 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 (continued)

<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 call options covering such leased assets, or both*</td>
<td>These contracts 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.</td>
</tr>
<tr>
<td>Operating leases (in which the legal entity is the lessor) with an embedded residual value guarantee, a non-fair-value-based purchase option (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 Section 6). |

Table 4-2 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. 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 Nonvariable Interests

<table>
<thead>
<tr>
<th>Financial Instruments or Other Contracts</th>
<th>Comments</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Assets of the legal entity</strong></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><strong>Options, guarantees, and similar financial instruments or contracts written by a legal entity</strong></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><strong>Other derivatives</strong></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><strong>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</strong></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><strong>Operating leases in which the legal entity is the lessor (in the absence of a residual value guarantee, non-fair-value-based purchase options (i.e., lessee call options), or other similar provisions)</strong></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

**ASC 810-10**

**55-22** 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.

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 VIE’s variability. However, if a VIE has a contract with one of its equity investors (e.g., the VIE 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 VIE, that equity investment is not at risk and would not be considered a variable interest. Section 4.3.1.1 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 below, 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, redeemable at the sponsor’s option, 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, similarly 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.

![Diagram of Reverse Trust Preferred Structure]

### 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.

![Diagram of Treasury Stock Financing Arrangement]
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.

ASC 810-10-55-24 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 receivable 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 or no risk to the variable interest holder. However, the variable interest holder would still need to assess whether the interest represents an obligation to absorb losses of the VIE or the right to receive benefits from the VIE that could potentially be significant when identifying the primary beneficiary. (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.

A reporting entity should not apply the guidance in ASC 810-10-25-35 and 25-36 when it has other involvement with the legal entity (e.g., when it holds equity, debt, or other contractual arrangements) and should not apply it to other types of contracts that do not possess the specified characteristics. Rather, a reporting entity should apply the other provisions discussed in Sections 4.2.1 and 4.3 to evaluate whether all of its interests are variable interests.
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.
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 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

<table>
<thead>
<tr>
<th>ASC 810-10</th>
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</thead>
<tbody>
<tr>
<td><strong>55-25</strong></td>
</tr>
<tr>
<td><strong>55-26</strong></td>
</tr>
</tbody>
</table>
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, the arrangement could result in consolidation of a “silo” within a VIE (see Section 6).

Finally, 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.

### 4.3.5 Forward Contracts

<table>
<thead>
<tr>
<th>ASC 810-10</th>
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<tbody>
<tr>
<td><strong>55-27</strong></td>
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<tr>
<td><strong>55-28</strong></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 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 Section 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.
Section 4 — Variable Interests

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 pricing of the contract, including whether the contract 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 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 4-3 — Purchase and Supply Contracts

<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>
<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 enterprise. 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 that otherwise would be allocated to the investors. See also Example 5-34, 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 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, 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 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 under ASC 840 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. See Section E.5.2.1 in Appendix E for comprehensive guidance on how to evaluate these types of contracts.

**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.
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 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). 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). In addition, the arrangement could result in consolidation of a “silo” within a VIE (see Section 6).

4.3.8 Embedded Derivatives

**ASC 810-10**

**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.

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 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 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 pursuant to ASC 840.

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 nonvariable interest) pursuant to 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 certain of the legal entity’s assets 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 (e.g., purchase option or residual value guarantee), 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 Section 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 under ASC 840. 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.

**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 results in the capitalization of the asset with a corresponding financing obligation under the provisions of ASC 840. Subject to the consideration of whether the fair value of the assets subject to lease represent less than half of the fair value of the lessor entity’s assets (see Section 6), a capital lease represents a variable interest. 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 under ASC 840 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.

**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 Section 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 Section 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, 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).

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**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 protects B by absorbing variability in X. Although E does not legally own the assets of X, the total return swap generally protects B by transferring the 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.

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**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.
4.3.10.2 Determining When an Implicit Guarantee (Variable Interest) Exists in a Related-Party Transaction

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 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]

Note that ASC 810-10-25-49 through 25-54 clarify that a reporting entity should consider whether it holds an implicit variable interest in a potential VIE resulting from a related-party relationship, as well as from unrelated parties (see ASC 810-10-25-51 in particular).

In situations in which a lessee does not have an explicit contract with a potential VIE (lessor entity) that qualifies as a variable interest, 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. Since an operating lease is generally not a variable interest, there may be no explicit variable interests between the related-party lessor (potential VIE) and lessee. However, in some related-party relationships (e.g., when the holder of a variable interest in the lessor entity has the ability to exert its influence on the lessee enterprise) — even those without an explicit guarantee or purchase option — the lessee may protect the lessor entity from losses on the leased property, thereby creating an “implicit guarantee.” 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.

Determining whether an implicit guarantee exists is important to the analysis of a potential VIE 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 equity from the expected losses of the entity and (2) if an implicit guarantee exists, 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.

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.

An implicit guarantee, for example, could manifest in a decision to renew the lease at above-market rents or in compensation paid directly to the variable interest holder. 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 capital lease from a related party, Real Estate Company (Real Estate), which is wholly owned by the majority shareholder of Operating. Real Estate (a VIE) was capitalized with $30,000 of equity from the majority shareholder and $970,000 of bank debt, with recourse to the assets of Real Estate and to the personal assets of the majority 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 under ASC 840. The operating lease is the only contractual relationship between Operating and Real Estate.
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 the majority shareholder’s investment in Real Estate and the majority shareholder’s personal guarantee of Real Estate’s debt:

- **Step 1** — The majority 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** — The majority 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 no other factors indicate that the majority 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 the majority shareholder). Although Operating and the majority shareholder are related, both operating (i.e., through its implicit guarantee of the assets of Real Estate) and the majority 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 characteristics and should consolidate Real Estate. If neither Operating nor the majority 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.

This analysis would most likely result in Operating’s consolidation of Real Estate as the primary beneficiary because it appears that Operating has both (1) the power to direct the activities of Real Estate that most significantly affect Real Estate’s economic performance and (2) the obligation to absorb losses of Real Estate that could potentially be significant to Real Estate. The economic performance of Real Estate is significantly affected by the value of its sole real estate asset at the end of the long-term lease with Operating. Operating’s ability to control the real estate asset over the lease term gives it the power to direct the activities that have the most significant impact on Real Estate’s economic performance. In addition, by virtue of the implicit guarantee, Operating would have the obligation to absorb losses that could potentially be significant if it has to reimburse the majority shareholder for Real Estate’s losses.

### 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:
  - If 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.
Example 4-16 (continued)

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. See Section 3.5 for more information about qualifying for this accounting alternative.

4.3.11 Variable Interests in Specified Assets

**ASC 810-10**

**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.

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 Section 6 for additional information on silos.

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 Section 6 for additional information on silos.
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 target 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 in ASC 810-10 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
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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 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 Section 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 interests 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 interest (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. If a related party is under common control, the reporting entity should carefully evaluate the facts and circumstances.

Example 4-19

Enterprises A and B are related parties (see Section 8). Individually, A has a variable interest in VIE X. Individually, 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, and B has an indirect interest in X through its direct 20 percent ownership in A, B should also consider its interest in A when determining whether it has a variable interest in X.

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.

f. 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:

- Those related to guarantees of the value of the assets or liabilities of a VIE
- Obligations to fund operating losses
- Payments associated with written put options on the assets of the VIE
- 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.

**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:

- 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.
- 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 5.3.1.3.1) and whether the decision maker is required to consolidate the VIE.

Before ASC 810-10 was amended by ASU 2015-02, six criteria had to be met before a reporting entity could conclude that a decision maker’s or service provider’s fee does not represent a variable interest. ASU 2015-02 eliminated the criteria related to the fee’s priority level and significance. Accordingly, 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:

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.

In addition, 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).

4.4.1 “Commensurate” and “At-Market” Fees

Reporting entities must determine whether fees paid to decision makers or service providers represent a variable interest and whether such interests represent a variable interest should be included in the evaluation of whether the economics criterion (see Section 7.3). A reporting entity is able to conclude that (1) fees paid to a decision maker or service provider do not represent a variable interest and (2) fees paid to a decision maker or service provider that do represent a variable interest should not be included in the evaluation of the economics characteristic only if both of the following apply:

- The fees are “commensurate” (i.e., they are compensation for services provided and are commensurate with the level of effort required to provide those services).
- The 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 servicer 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). 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.

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).

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).

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 4-22

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 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, 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 the Basis for Conclusions 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) satisfies the economics criterion or (2) is a variable interest. 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) exclusion from the primary-beneficiary evaluation or (2) the fee arrangement evaluation under ASC 810-10-55-37.

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.

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.
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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.
- 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, 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.

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

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2 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.

3 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).
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. 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 VIE 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 VIE.

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.

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 810-10-25-38 A(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 not satisfy the criterion in ASC 810-10-55-37(c), and A would meet both characteristics in ASC 810-10-25-38A.

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 “Insufficient” 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 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, 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 VIE.

The analysis under ASC 810-10-55-37(c) deals with the expected outcome of the 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 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 the Basis for Conclusions 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.

Once the fee crystalizes (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).

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, 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.

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.
Section 4 — Variable Interests

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 2015-2 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 Section 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 the Basis for Conclusions 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.”

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 the Basis for Conclusions of ASU 2015-02. The diagram in Example 4-33 below illustrates this relationship.

Example 4-33
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.
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 Codification 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 the Basis for Conclusions 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.

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 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 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 applying ASC 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 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 its 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.

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**Example 4-35**

<table>
<thead>
<tr>
<th>Asset Manager (Reporting Entity)</th>
<th>Fee Arrangement</th>
<th>Offshore Feeder Fund (Voting Interest Entity)</th>
<th>Unrelated Investors</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>25% Interest</td>
<td></td>
<td></td>
</tr>
<tr>
<td>0.1% General Partner Interest</td>
<td></td>
<td>30% Limited Partner Interest</td>
<td></td>
</tr>
<tr>
<td>Master Fund (VIE)</td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>
Example 4-35 (continued)

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 810-10-14-15(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 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 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 Section 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.
Section 5 — Determining Whether a Legal Entity Is a VIE

5.1 Introduction

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 Section 9 for a discussion of VIE reconsideration events). If the legal entity is a VIE, the reporting entity with a variable interest (see Section 4) in that legal entity applies the VIE provisions of ASC 810-10 to determine whether it must consolidate. 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 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 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 due to insufficiency of equity investment at risk, when those attributes become those of the parent, the parent may also be determined to be a VIE unless the parent has other substantive activities or consolidated subsidiaries.

### 5.2 Sufficiency of Equity

**ASC 810-10-15-14(a)**

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 variable interest entity [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 enough 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.

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, 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.

Any such interests that are not classified at the time of evaluation as equity for accounting purposes cannot meet the definition of an equity investment. This applies even if an interest classified outside of equity has characteristics that are very similar to equity (e.g., a shareholder loan).

### 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 are considered at risk because they 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). In addition, ASC 480-10 requires that certain instruments previously classified as temporary or mezzanine equity under the guidance in ASC 480-10-S99-3A be reclassified as liabilities (or assets in certain circumstances). Instruments classified as assets or liabilities do not qualify for inclusion in total equity investment at risk.

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, subordinated intercompany 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:

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.

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 instruments 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, 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.
- Not be financed by the legal entity or other parties involved with the legal entity.
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. In contrast, instruments that participate in the profits and losses of specified assets are not 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 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 in the profits and losses of the limited partnership as a whole. 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 Section 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. Occasionally, 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). In such cases, 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.

5.2.2.1.2 Contracts and Instruments That Protect an Equity Investor

Contracts or 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) 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.

**Example 5-5**

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 the parent, a subsidiary, or an affiliate of the equity investor when that party is required to be included in the same 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*

Equity investments acquired by an equity investor in exchange for promising to perform services 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.1

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1 This condition may be an indicator of a de facto agency relationship under ASC 810-10-25-43(b). See Section 8.2.3.2.
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.

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. Enterprise A has financed its equity investment by obtaining a loan directly from another party that is involved with D. In addition, B does not have to be included in A’s consolidated financial statements. Therefore, A’s $100 contribution would not qualify as equity investment at risk.
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:

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<tbody>
<tr>
<td>Purchases a physically settled, fixed-price put on its equity investment.</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>Writes a physically settled, fixed-price call on its equity investment.</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>Enters into a net-cash-settled total return swap indexed to the all-in return on its equity investment.*</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>Purchases a physically settled, fixed-price put on its equity investment.</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 from the potential VIE to finance the original reporting entity’s investment in the potential VIE.</td>
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### Table 5-1 — Analysis of Equity Interests (continued)

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<tr>
<td>Writes a physically settled, fixed-price call on its equity investment.</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 “financed” by the potential VIE.</td>
</tr>
<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 from the counterparty to finance 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 “financed” 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 4.3.7.</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 underlying entity.

### 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...
Section 5 — Determining Whether a Legal Entity Is a VIE

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 based 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 the ability to 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).

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 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.
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 loss (see Appendix C for guidance on calculating expected losses). In its simplest form, the quantitative analysis can be characterized as follows:

**Equity investment at risk > Expected losses = Sufficient equity**

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.

### 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.
Section 5 — Determining Whether a Legal Entity Is a VIE

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 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 Section 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 A and 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.
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 equity, 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

ASC 810-10

15-16 Because reconsideration of whether a legal entity is subject to the Variable Interest Entities Subsections is required only in certain circumstances, the initial application to a legal entity that is in the development stage is very important. Guidelines for identifying a development stage entity appear in paragraph 915-10-05-2. A development stage entity is a VIE if it meets any of the conditions in paragraph 810-10-15-14. A development stage entity does not meet the condition in paragraph 810-10-15-14(a) if it can be demonstrated that the equity invested in the legal entity is sufficient to permit it to finance the activities it is currently engaged in (for example, if the legal entity has already obtained financing without additional subordinated financial support) and provisions in the legal entity’s governing documents and contractual arrangements allow additional equity investments. However, sufficiency of the equity investment should be reconsidered as required by paragraph 810-10-35-4, for example, if the legal entity undertakes additional activities or acquires additional assets.

Pending Content

Transition Date: (P) December 16, 2015; (N) December 16, 2016 | Transition Guidance: 810-10-65-5

15-16 Paragraph superseded by Accounting Standards Update No. 2014-10

ASC 915-10-20 defines a development-stage entity as follows:

An entity devoting substantially all of its efforts to establishing a new business and for which either of the following conditions exists:

a. Planned principal operations have not commenced.

b. Planned principal operations have commenced, but there has been no significant revenue therefrom.

Until the adoption of ASU 2014-10, certain entities can 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.

Recognizing this distinction, the FASB provided a different framework for evaluating the sufficiency of equity investment at risk for all development-stage entities. For equity investment at risk to be considered sufficient for a development-stage entity, two conditions needed to be present:

• The legal entity must have had sufficient equity to fund its current developmental activity.

• The legal entity must have been legally structured to permit additional equity investment in the future, to fund further development upon completion of the current activity.

This framework is more generous than the approach applicable to entities that do not qualify as development-stage entities since it takes into account the life cycle of the legal entity in phases rather than over the entire contemplated life of the legal entity. Accordingly, a reporting entity applying this framework should carefully support its conclusion under ASC 915, and the framework should not be applied by analogy. Further, a specialized approach would apply only to the sufficiency of equity investment at risk; an assessment of the other conditions of a VIE would still need to be performed for such legal entities.

A reporting entity should initially assess whether a development-stage entity is a VIE on the date 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).

2 ASU 2014-10 eliminates the specialized approach for considering sufficiency of equity investment at risk for development-stage entities. That guidance is 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 is effective for annual periods beginning after December 15, 2016, and for interim periods beginning after December 15, 2017. Early adoption is permitted. Reporting entities that have historically applied this exception should consider the impact of ASU 2014-10 on their historical conclusions.
Although the concept of a development-stage entity has been removed in ASU 2014-10, we believe 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, for certain legal entities that met the definition of a development-stage entity under previous guidance, 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 a substantive contingency exists, see Section 7.2.9.2.

Note that upon adoption of ASU 2014-10, only certain legal entities that previously met the definition of a development-stage entity could apply this concept. That is, not all previously termed “development-stage entities” would have substantial uncertainty in proceeding to the next stage.

Example 5-17

Entity D is a development-stage entity as defined in ASC 915. 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. When assessing the sufficiency of equity at risk under ASC 810-10-15-14(a), D need only consider the current phase of its development. 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 collectively do not possess the characteristics that are typical of equity interests. Accordingly, a legal entity is considered a VIE if any of the following three qualities — the “typical” characteristics of an equity investment — are absent from the holders of equity investment at risk as a group:

- 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 interest itself and not a characteristic of other interests held by the current holders of the equity interests. 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 interest 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, 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 equity investors as a group lack one or more of the three characteristics:

1. Holders of variable interests other than equity (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 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 (two investors each hold $50 million of the 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 equity investors, as a group, fail to possess the power-to-direct characteristic (see Section 5.3.1 below). 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(b)(1)

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 variable interest entity [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 B10-10-25-2 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.
Section 5 — Determining Whether a Legal 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). If an interest or party outside the equity investment at risk is making the decisions (or can prevent the group of equity investors at risk from unilaterally making the decisions) that most significantly affect the economic performance of the legal entity, the legal entity would be considered a VIE (regardless of the sufficiency of the equity).

The legal form of a legal entity (e.g., corporation, partnership, LLC) affects its governance and, accordingly, which party has the ability to make decisions. Legal entities structured as a limited partnership are required by partnership law to have a general partner responsible for governing the limited partnership. By their nature, such entities have 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 legal entity. See Section 5.3.1.2.1 for a discussion of what is meant by a “similar entity.”

5.3.1.1 The Power to Direct the Most Significant Activities of an Entity Other Than a Limited Partnership (or Similar Entity)

The evaluation of whether the 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 equity-holder group 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 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 party 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 equity group substantively participates in the most significant activities.

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.
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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), the 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 entity’s legal 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-REMICs) 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 the most significant activities of the entity unless the holders of the equity investment at risk have the unilateral ability to change the governing documents or contractual arrangements without the approval of other parties, such as lenders. If the equity holders have this unilateral ability, 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.

All of the significant decisions related to the trust have been specified in the trust’s creation documents. 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. In addition, neither ServicerCo nor the holders of the trust’s beneficial interests have the ability to change the governing documents of the trust. 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 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 embedded 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.

3 Re-REMICs are resecuritizations of real estate mortgage investment conduit securities.
Example 5-20

Assume that a legal entity is formed by the issuance of equity 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 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 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 (that does not qualify for the business scope exception) 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 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 consent requirement is substantive.⁴

⁴ For a consent requirement to be substantive, the other equity investors at risk must be able to withhold their consent without limitation. (Consequently, consent that cannot be unreasonably withheld is not substantive.) A consent requirement may also not be substantive if the other equity investors are related parties or de facto agents of the decision maker.
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 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 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?

In evaluating whether a decision maker has a variable interest in the legal entity, the reporting entity must first determine whether there is a decision maker. 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.

However, the mere existence of a decision maker in a legal entity does not mean that the equity holders as a group do not have the power to direct that legal entity’s most significant activities. 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 does not hold 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 holders 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 equity holders) 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 Voting Rights (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

\footnote{Although participation rights must also be considered, as discussed in Section 5.3.1.3.5, we do not believe that such rights have the same impact on the VIE determination as kick-out rights in this context.}
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 in the Basis for Conclusions 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 through 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 equity holders, the equity 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:

<table>
<thead>
<tr>
<th>ASC 810-10</th>
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<tbody>
<tr>
<td><strong>55-8A</strong></td>
</tr>
<tr>
<td><strong>55-8B</strong></td>
</tr>
<tr>
<td><strong>55-8C</strong></td>
</tr>
<tr>
<td>a.</td>
</tr>
<tr>
<td>b.</td>
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</tbody>
</table>
Section 5 — Determining Whether a Legal Entity Is a VIE

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 the Basis for Conclusions 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 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 (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 equity investor at risk has the ability 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 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 equity investors only temporarily at the discretion of the single 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 the Basis for Conclusions 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.

5.3.1.1.3.5 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 equity investor 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:

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 equity investor 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 among equity and nonequity holders; for a legal entity to be a voting interest entity, only the equity holders may have power.

We therefore believe that it would be unusual for a substantive participating right held by a single 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.

5.3.1.2 The Power to Direct the Most Significant Activities of a Limited Partnership (or Similar Entity)

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 rather than 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).

As a result of ASU 2015-02, limited partnerships that do not have substantive kick-out or participating rights, but historically were not considered VIEs, will need to be evaluated under the new VIE consolidation model. Even if a reporting entity determines that it does not need to consolidate the limited partnership under the VIE requirements in ASU 2015-02, it would have to provide the extensive disclosures currently required for any VIEs in which it holds a variable interest. On the other hand, partnership arrangements that include substantive simple majority kick-out or participating rights may no longer be VIEs.
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, or in which a nonmanaging member is 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.

### 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 5-22

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/unrelated 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.

General Partner (Holds Limited Partner Interests)  Unrelated Limited Partners

<table>
<thead>
<tr>
<th>20%</th>
<th>80%</th>
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Limited Partnership

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 5-23 through 5-27 below, 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 5-27, in which the limited partners have unequal partnership interests).

Example 5-23

A limited partnership agreement requires a simple majority of the limited partner voting interests to remove the general partner. Assume that a limited partnership has three limited partners, none of which have any relationship to the general partners, 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 that requires a vote of two of the limited partners 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 5-24

Assume the same facts as in Example 5-23, 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 that requires a vote of both limited partners to remove the general partner, would meet the requirements for a substantive kick-out right.

Example 5-25

Assume the same facts as in Example 5-23, 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 that requires a vote of less than 52 limited partners 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 5-26

A limited partnership agreement requires a vote of 66.6 percent of the limited partner voting interests to remove the general partners. 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 partners. 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 5-27

A limited partnership agreement requires a vote of 66.6 percent of the limited partner voting interests 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 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 right by LP2 and LP3 also would represent a simple majority of the limited partners; however, their voting interests (55 percent) would not meet the required threshold of 66.6 percent to remove the general partners. Accordingly, the kick-out right under this scenario 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.

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.
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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 the Basis for Conclusions 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 limited partner controls technology that is critical to the limited partnership, or the limited 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.
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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 organization 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:

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.

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:

As discussed in Section 7.2.10.3, paragraph BC49 of the Basis for Conclusions 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 substantive6 and (2) gives a simple majority (or lower threshold)7 of limited partners 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 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. 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.

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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.
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.

5.3.1.2.6 Evaluation of Buy-Sell Clauses as a Liquidation Right

A buy-sell agreement could take various forms, but generally permits one investor to initiate the purchase or sale of another investor's interest. These provisions would not typically be considered a liquidation right.

Example 5-28

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 (typically, selecting and terminating management and setting its compensation or making operating and capital decisions) rather than in the most significant activities of the entity.

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.

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**

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**

<table>
<thead>
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<th>ASC 810-10-15-14(b)(2)</th>
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| 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 variable interest entity [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 Section 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 an investor transfers to its interest in 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 5-29

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 Section 6.

Example 5-30

Assume the same facts as in Example 5-29 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.

Example 5-31

Assume the same facts as in Example 5-29 except that the guarantors of the real estate assets are related parties. As in Example 5-30, 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 5-32

Assume the same facts as in Example 5-29 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 5-30 and 5-31, the guarantee is related to a majority of C’s total assets; thus, the guarantors 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 equity holder or holders 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 an equity investor 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 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 5-33

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 5-34

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 5-35

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

ASC 810-10-15-14(b)(3)

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 variable interest entity [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 if 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 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. The distinction in these instruments is the alignment of return and equity ownership. However, it is not correct that only equity holders 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 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 equity investors 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.
This indicates that the right to the legal entity’s return under GAAP must not be capped to qualify as a voting interest entity. 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 5-36**

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 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 equity holders’ 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 equity holders.

**Example 5-37**

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 equity holder’s right to receive residual returns pursuant to ASC 810-10-15-14(b)(3) (i.e., the equity investors of A do not participate in the appreciation in value of the related equipment), A would be a VIE.
5.4 Nonsubstantive Voting Rights

**ASC 810-10-15-14(c)**

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 variable interest entity [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), 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.
In practice, however, this analysis will not be so simple. 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 parties must consent to any 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 (e.g., if a 66.6 percent threshold is required for a decision and the two investors hold 60 percent and 40 percent).

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 Sections 2.14 and 4) by reference to the obligation to absorb expected losses and 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).
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.

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 corporation 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. 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.

Company B and Company D are equity investors in Conglomerate T and hold 90 percent and 10 percent voting interests, respectively. Company B controls T through its 90 percent voting interest and is exposed to 60 percent of T’s profits and losses. 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 Are 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 of its de facto agents). 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 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.

8 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.
Section 5 — Determining Whether a Legal Entity Is a VIE

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.

“Substantially all” is a high threshold. We are aware of interpretations of this term in practice to mean 90 percent or more on the basis of SEC staff language, among other things; however, we reject the application of a strictly quantitative approach. There may be circumstances in which a qualitative analysis is sufficient — for example, an investment fund in which substantially all of the expected residual returns and expected losses of a legal entity accrue to one party.

A reporting entity will generally need to perform a qualitative analysis to determine whether substantially all of the activities of a legal entity 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 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?

None of these factors is necessarily determinative in and of itself. 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 5-41**

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, JV would be a VIE because it lacks the characteristic in ASC 810-10-15-14(b)(1).

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.

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9 See footnote 8.
Example 5-42

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 Entity 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).

Example 5-43

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 5-44

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 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 5-43 above.) Therefore, ASC 810-10-15-14(c)(2) is not met, and Y is not a VIE.
Section 6 — Interests in Specified Assets of the VIE and 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.

25-59 Acquisition, development, and construction loan structures may be VIEs subject to the guidance in the Variable Interest Entities Subsections. Guidance on determining whether a lender should account for an acquisition, development, and construction arrangement as a loan or as an investment in real estate or a joint venture is presented in Subtopic 310-10.

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 section 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 section, 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 silo concept exists solely within 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.
One approach to determining whether a silo exists and should be considered for consolidation separately from the legal entity as a whole is to ascertain whether all of 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 remainder of the assets of the legal entity.
- The legal entity that remains (the “host entity”) is a VIE.

The following flowchart outlines the reporting entity’s analysis of whether a silo exists and should be considered for consolidation.

6.2 Evaluation of Silos

As discussed in Section 6.1, a silo will typically exist 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 remainder of the assets of the legal 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 $25</td>
<td>Accounts payable $15</td>
</tr>
<tr>
<td>Other assets $85</td>
<td>Debt* $155</td>
</tr>
<tr>
<td>Building $160</td>
<td>Equity $100</td>
</tr>
<tr>
<td><strong>Total assets $270</strong></td>
<td><strong>Total liabilities and equity $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.
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 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 Section 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).
Section 7 — Determining the Primary Beneficiary

1. Evaluate under VIE model.
2. Does the reporting entity have power and significant economic exposure (through its direct and indirect interests)? (Sections 7.2 and 7.3)
   - Yes: Reporting entity consolidates the VIE.
   - No: Does the reporting entity share power with a related party and does the related-party group have 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: Do related parties under common control have power and significant economic exposure? (Section 7.4.2.3)
       - Yes: That single variable interest holder in the related-party group consolidates the entity.
       - No: Does the related-party group have power and 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: Stop consolidation analysis.*
         - No: Stop consolidation analysis.**

* Consolidation is not required; however, other GAAP may be relevant to determine 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). Upon the adoption of ASU 2015-02, 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 residual returns 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 section 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 (see Section 3), (2) it has a variable interest in a legal entity (see Section 4), and (3) the legal entity is a VIE (see Section 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 that 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 Basis for Conclusions of Statement 167 states that “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.”
ASU 2015-02 did not amend the concept that a primary beneficiary must hold a variable interest. In fact, ASU 2015-02 further supports this principle, as evidenced by the decision tree in ASC 810-10-05-6, which instructs the reporting entity to “[s]top [the] consolidation analysis” and consider other relevant GAAP if the reporting entity does not have a variable interest in the VIE. See Section 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.

7.1.2 Multiple Primary Beneficiaries

It is inappropriate for more than one reporting entity to consolidate the same VIE. However, because 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, when 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 Section 3).
- The legal entity is not a VIE (see Section 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. 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 Section 9). The subsequent reassessments are not limited to the end of each reporting period. The requirements to perform continual assessments of whether a reporting entity is the primary beneficiary of a VIE are consistent with those for voting interest entities (see ASC 810-10-45-4).

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) 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.
Section 7 — Determining the Primary Beneficiary

7.2  Power Criterion

ASC 810-10

25-38B  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.

25-38F  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.

25-38G  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.

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 significant decisions related to the risks identified in step 1 and the activities associated with those risks. In certain situations in which multiple unrelated variable interest holders direct different decisions and 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 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. In addition, the reporting entity should consider all the risks and associated variability that the VIE was designed to create and
that are absorbed by any of the variable interests in the VIE. 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 variability1), 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.

### 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)?
  - 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?
  - Is there another party or other parties that direct the same activities but for a different portion of the VIE’s assets?
- Is the reporting entity’s right to exercise power currently available or contingent on the occurrence of some other event(s)?

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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.

### 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 and the manager is only providing management services as an agent on behalf of the equity investors, 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 a 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.

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 the ability to kick out the manager.

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.
Example 7-1 (continued)

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. 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 had removal of W been allowed by a simple majority vote of the board of directors, 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
Section 7 — Determining the Primary Beneficiary

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 that the VIE is designed to create and pass along. 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 substantially all of the variability and economics of the VIE.

The above speech was delivered before the issuance of ASU 2015-02. Although the concepts are still relevant, ASU 2015-02 broadens the evaluation of whether a decision maker is acting as an agent by permitting decision-maker fees to be significant as long as they are commensurate and at market (see Sections 4.4 and 4.4.1). We do not believe this speech should apply when, for example, a decision maker receives fees that significantly participate in the economic performance of the VIE. 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)

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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:

1. Is power over the activity or activities that most significantly affect the economic performance of the VIE considered shared?
   - No
   - Are there multiple activities that are different in nature and that most significantly affect the economic performance of the VIE that are directed by multiple unrelated parties?
     - No
     - Does one party have the power over the majority of the activity or activities?
       - No
       - There is no primary beneficiary.
     - Yes
       - Yes
       - The party with power over the activity or activities that most significantly affect the VIE’s economic performance has the power to direct the activities of the VIE that most significantly affect the VIE’s economic performance.
     - 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.

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 the decision-making 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.
Example 7-3

Companies A, B, and C 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 other 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 A, B, and C. 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 A, B, and C were related parties (or de facto agents), control would still not be considered shared. Accordingly, they would not perform the related-party tiebreaker test (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 A, B, and C 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.”

Example 7-5

Assume the same facts as in Example 7-3, except that Company A performs all activities related to the creative process, Company B performs all activities related to the customer accounts, and Company C 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.
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 companies do not have any other 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 determining whether one party in the related-party group has both of the characteristics of a controlling financial interest.

In these circumstances, the reporting entity may need to consider all relevant facts and circumstances, including the guidance in ASC 810-10-25-44(a)–(d). If one party in the related-party group appears to be most closely associated with the VIE on the basis of the guidance in ASC 810-10-24-44(a)–(d), but the stated power arrangements indicate that another party in the related-party group has both of the characteristics of a controlling financial interest in ASC 810-10-25-38A, the stated power of the parties may not be substantive. Chris Rogers discussed the concept of nonsubstantive power in common-control scenarios in his speech at the 2014 AICPA Conference on Current SEC and PCAOB Developments. Mr. Rogers cautioned that although care should be taken in the identification of nonsubstantive power in common-control scenarios, they do not always need to be evaluated under the related-party tiebreaker guidance. He stated:

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 that guidance is necessarily determinative unless no party in the common control group individually meets both characteristics of a primary beneficiary. [Footnotes omitted]

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) and other business factors (e.g., whether a reporting entity holds a call option on an asset that is critical to its business operations).

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) may be more likely to have a meaningful impact on the analysis of VIEs with a limited life or limited range of activities. This is because significant decisions often must be made about the strategic direction of operating entities over time (as opposed to decisions about many limited-life entities, including, but not limited to, SPEs). Decisions must also routinely be made about capital and resource deployment/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 of forward starting rights (e.g., call options exercisable on a future date or other forward starting contracts).

Note that a reporting entity will need to use judgment to distinguish between forward starting rights that are not subject to a contingency (i.e., rights that are exercisable simply on the basis of the passage of time) and other situations in which a party’s ability to direct the most significant activities of a VIE is contingent on the occurrence of a future event. The latter situation is discussed in Section 7.2.9.2.

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**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.

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**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.

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### 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 Examples 7-9 and 7-10 below, the latter in Example 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 consider decisions that would be made until the contingency is 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 of the substantive contingency of the occurrence of those events.
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 R&D activities to develop and obtain FDA approval for the drug (stage 1), 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 R&D 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.

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 A unilaterally controls the operations of C, A would be deemed to have the power over the most significant activities. That is, the contingent event (completion of the plant) initiates A’s power.

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. 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

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 Codification Master Glossary defines a kick-out right for a VIE as the “ability to remove the reporting 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 Codification 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

In the determination of whether a kick-out right is substantive, one consideration is whether there are any significant barriers to exercising the right. 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 included 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.

The assessment of whether kick-out rights are substantive should be based on a consideration of all relevant facts and circumstances.

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 factors a reporting entity should consider when evaluating whether a board of directors has the power to direct the activities of a VIE that most significantly affect the VIE’s economic performance.

### 7.2.10.3 Withdrawal and Liquidation Rights

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 the Basis for Conclusions 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 explicitly 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.

### 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. Participating rights have a separate VIE definition.

<table>
<thead>
<tr>
<th>ASC 810-10-20</th>
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<tbody>
<tr>
<td><strong>Participating Rights</strong></td>
<td>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.</td>
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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.

The evaluation of participating rights in the primary-beneficiary assessment is consistent with the evaluation of participating rights in determining whether the equity holders have power in the VIE assessment. See Section 5.3.1.1.3.5 for a discussion of the impact of substantive participating rights on the VIE assessment.

### 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 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. Said simply, the variable interest holder must have an exposure to the economics 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 (i.e., expected losses, expected residual returns, or expected variability analysis) 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 the Basis for Conclusions 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 that a quantitatively insignificant interest meets the economics criterion on the basis of qualitative factors and an overall consideration of its quantitative and qualitative assessments. 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 represent more than an insignificant amount of the entity’s expected losses or expected residual returns).

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 scenario 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 that scenario would be significant relative to the VIE’s performance in that scenario, even if the level of losses incurred or benefits generated by the VIE in that scenario is not quantitatively significant to the VIE.

**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 on which the purpose and design of the VIE is based.

**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, 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.

### 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

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| **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 810-10-25-38I) 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.
ASC 810-10 (continued)

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, under the revised consolidation requirements, fees paid to a VIE’s decision maker or service provider should not be considered in the evaluation of the economics criterion, regardless of whether the reporting entity has other economic interests in the VIE, if the fees are “commensurate” and “at market” (see Section 4.4.1 for a discussion of determining whether the fees meet these criteria) and the fee does not expose the reporting entity to risk of loss (see Section 7.3.4.2). Paragraph BC42 of the Basis for Conclusions of ASU 2015-02 describes the Board’s rationale for excluding these fees in the economics-criterion evaluation as follows:

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 the Basis for Conclusions 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.

As discussed in Example 7-14, in analyzing whether a fee that is not commensurate or at market itself 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 its direct economic interests in the entity and its indirect economic 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), considered on a proportionate basis. 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 interest would be considered equivalent to an 8 percent direct interest in the VIE for purposes of evaluating the characteristic in paragraph 810-10-25-38Ab (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 decision maker’s employees have a 30 percent interest in the VIE and one third of that interest was financed by the decision maker, then the single decision maker’s interest would be considered equivalent to a 10 percent direct interest in the VIE. 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.

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. In addition, the effects of interests held by a related party will be different depending on the reporting entity’s relationship with the related party. Specifically, whether those interests are included in the economics criterion determination on a proportionate basis or in their entirety will depend on whether the related parties or de facto agents are entities under common control of the reporting entity (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 fixed and incentive fee that is 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 fee since it is 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.

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.

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...
Section 7 — Determining the Primary Beneficiary

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 Including 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 Section 8.2.2 for further discussion of what is meant by “common control.” In these cases, because the related party is under common control, the reporting entity must include the related party’s entire interest in its economics-criterion evaluation. 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 test 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).

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 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 fee arrangement is a variable interest because it does not meet the condition in ASC B10-10-55-37(c).

When A and B evaluate whether they are the primary beneficiary of C (and therefore are required to consolidate C), each is required to first consider only its own respective interests in the VIE. Accordingly, A would conclude that it meets the power criterion and the economics criterion on its own. That is, A must treat B’s 30 percent equity interest as its own because A has an interest in B, and B is under common control. Therefore, A would meet both the power and economics criteria and would consolidate C.

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. However, if the decision maker has a direct interest in the related parties, the effect of variable interests that are held by a decision maker’s related parties that are not under common control is significantly different from the effect of those under common control. That is, if the related parties are not entities under common control, a decision maker should include its indirect interests held through its related parties (or de facto agents) on a proportionate basis (rather than in their entirety).
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 solely as a result of interests held by 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 legal 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

ASC 810-10

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.
Section 7 — Determining the Primary Beneficiary

ASC 810-10 (continued)

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.

25-44B 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, a reporting entity 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 related-party group is required to consolidate the VIE, and (3) 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.
The following flowchart illustrates when the related-party tiebreaker test is required and when the “substantially all” characteristic is met:

**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 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:

- Power is “shared” within a related-party group and the related-party group meets both characteristics of a controlling financial interest. See Section 7.2.7.2 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 8.2.2 for further discussion of 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 below 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 an unrelated party and together they control the most significant activities in the VIE because they do not share power. 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 the 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 the 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.

We expect that the related-party tiebreaker guidance will apply in extremely limited situations to a single decision maker and its related parties under common control. A determination that the decision maker meets the power criterion through a fee arrangement is most likely to have been made if the decision maker has a direct or indirect economic interest in the VIE that absorbs more than an insignificant amount of the VIE’s variability (see Section 4.4.2). In addition, when performing the economics-criterion assessment, the decision maker is required to consider interests held through related parties under common control as if they were held directly by the decision maker (see Section 7.3.5.1). Therefore, the related-party tiebreaker guidance would apply to single decision makers and their related parties under common control only if either (1) the decision-maker fees were not commensurate
or at market but do not meet the economics criterion or (2) it was determined that the decision-maker fee arrangement was a variable interest because a common parent designed a VIE to separate power and economics in an effort to circumvent consolidation in the stand-alone financial statements of the decision maker or related party under common control (see Section 4.4.2.3.2).

Note that in instances in which the decision maker does not have a variable interest through the fee arrangement in a VIE but the related parties under common control 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 legal entity 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.

Example 7-22

Entity A and Entity B are under common control but do not have ownership interests in each other. Entity A is the general partner (decision maker) for Partnership C but does not own any of the limited partnership interests. Entity B owns 51 percent of C’s limited partner interests. The partnership is considered a VIE.

When A and B each consider only their own respective interests, neither party individually would have both of the characteristics of a controlling financial interest. Entity A would conclude that (1) it does not have a variable interest on its own (and therefore does not have power) unless the fee arrangement did not meet the commensurate and at-market conditions or (2) C was designed in a manner to circumvent consolidation in the stand-alone financial statement of A or B. In addition, B would conclude that it meets the economics criterion but not the power criterion. Therefore, because A’s fee arrangement is not considered a variable interest, the related-party tiebreaker test would not need to be performed, and neither A nor B would be required to consolidate C in its stand-alone financial statements. However, Parent would be required to consolidate C in its consolidated financial statements because it has both the power (indirectly through A) and economics (indirectly through B).

Note that if A had an explicit or implicit variable interest in B, A’s fee arrangement would be considered a variable interest, and A would be required to consolidate C.

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 are outlined below.

### Table 7-1 — Factors to Consider When Performing the Related-Party Tiebreaker Test

<table>
<thead>
<tr>
<th>Factor</th>
<th>Comments</th>
</tr>
</thead>
<tbody>
<tr>
<td>ASC 810-10-25-44(a): “The existence of a principal-agency relationship between parties within the related party group.”</td>
<td>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 605-45 to determine whether, by analogy, a principal-agency relationship exists.</td>
</tr>
<tr>
<td>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.”</td>
<td>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.</td>
</tr>
<tr>
<td>ASC 810-10-25-44(c): “A party’s exposure to the variability associated with the anticipated economic performance of the VIE.”</td>
<td>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.</td>
</tr>
<tr>
<td>ASC 810-10-25-44(d): “The design of the VIE.”</td>
<td>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.</td>
</tr>
</tbody>
</table>

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

Entities A and 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 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 the factors in ASC 810-10-25-44 with respect to B, in this example, consideration of all the factors seems to indicate that A is most closely associated with X, and it may be reasonable to conclude that A would be considered the primary beneficiary.

**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.

Accordingly, 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 (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)).
Example 7-26 (continued)

While the fee arrangement is considered a variable interest, 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 VIE (i.e., it does not meet the economics criterion). 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 is required to consolidate a VIE if (1) the reporting entity is a related party to a single decision maker that does not, individually, have both of the characteristics of a controlling financial interest, (2) the single decision maker and its related parties under common control do not have both characteristics of a controlling financial interest, and (3) 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 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, 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, under ASU 2015-02, B would be required to consolidate the fund because the related-party group possesses the characteristics of a primary beneficiary, and 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 a 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.
Section 8 — Related-Party Considerations

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 section, the identification of related parties and de facto agents is addressed in Section 8.2, 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

ASC 810-10 defines the term “related parties” as follows:

- Affiliates of the entity
- 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

ASC 850-10-20 defines the term “related parties” as follows:

- Subparaphraph superseded by Accounting Standards Update No. 2009-17
Section 8 — Related-Party Considerations

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, the parent entity (P) 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 P) 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, P (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 EMI1 are considered related parties in the assessment of which party should consolidate the joint venture.
Example 8-2

Parent

40% 25%
Equity Method Investee 1 Equity Method Investee 2

50% 50%
Joint Venture (VIE)

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. Parent entity (P) 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 P 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 P 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 the Basis for Conclusions 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.”

Example 8-3

Company R (Reporting Entity)

100% Ownership Interest

Unrelated Investors

1% General Partner Interest

99% Limited Partner Interest

Subsidiary A (Asset Manager)

1% General Partner Interest

Unrelated Investors

25% Limited Partner Interest

Fund

74% Limited Partner Interest

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.
Section 8 — Related-Party Considerations

Example 8-3 (continued)

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.

The parent in a parent-subsidiary 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 Codification Master Glossary defines “parent” as “[an entity that has a controlling financial interest in one or more subsidiaries” (emphasis added). In addition, given the FASB’s objectives, as described in paragraph BC69 of the Basis for Conclusions of ASU 2015-02, regarding the identification of related parties under common control in ASC 810-10-25-42, ASC 810-10-25-44A, and ASC 810-10-55-37D, a parent should include in its VIE analysis 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 typically result in a conclusion that the reporting entities are not under common control.

Example 8-4

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, 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. Said differently, not only the de facto principal is affected by this guidance.

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.

• “A party that received its interests as a contribution or a loan from the reporting entity” — Section 8.2.3.2.

• “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.

A fixed-price put option may also create a de facto agency relationship between the reporting entity and the counterparty to the put option because the fixed-price put option may be economically equivalent to a loan. For example, if a third-party entity has a fixed-price put option that would require the reporting entity to acquire its interest in a potential VIE, although the arrangement is not a loan or note, it may be economically equivalent to the other party’s receipt of a loan from the reporting entity to finance its interest in the potential VIE.

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 arms-length commercial transaction. A reporting entity must consider whether the loan was provided at market rates, similarly to rates for similar types of 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 the arrangement. For example, ASC 810-10-25-43(d) states that a de facto agency 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 only exists if such approval constrains the other party’s ability to manage its economic interest in the VIE. Whether such a restriction on 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, 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. Conversely, a de facto agency relationship is presumed if such language is absent from a contractual agreement or if the agreements only cite narrow specific circumstances that would not typically be encountered under which approval cannot be unreasonably withheld.

- 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, Company 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 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. Some considerations in this analysis should be, but is not 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”</td>
<td>All</td>
<td>All, except for “transfer restrictions”</td>
</tr>
<tr>
<td>(see Section 8.3.1)</td>
<td></td>
<td></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 certain interests held by related parties under common control</td>
<td>Any indirect interest through the de facto agent (other than employees)</td>
</tr>
</tbody>
</table>
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). 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.

Table 8-1 — Effect of Related Parties and De Facto Agents on VIE Analysis (continued)

<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>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 “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>
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, inter alia, 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 below 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>
<thead>
<tr>
<th>Table 8-2 — Consideration of Interests Held by Related Parties</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Decision Maker’s Interests</strong></td>
</tr>
<tr>
<td><strong>Always</strong> include the direct interests held by the decision maker in its evaluation.</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 equity holder,
Section 8 — Related-Party Considerations

including the equity 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 5.3.1.3.4 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. Under ASU 2015-02, a limited partnership is a VIE unless (1) a simple majority or lower threshold of the limited partners 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 is an investor that has disproportionately few voting rights relative to that investor’s economic exposure to a legal entity and (2) substantially all of the activities of a 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 below 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>Always</td>
<td>Include the entire related party’s interest (including employees and benefit plans) 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

ASC 810-10

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:

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.

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.

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.

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.

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.

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 section. 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 holders of equity investment at risk have changed. Generally, if a reporting entity concludes that the VIE status of a legal entity would change upon the occurrence of one of the reconsideration events, the event most likely would be considered significant enough to require reconsideration under the VIE model.

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).
Section 9 — VIE Reconsideration Events

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 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 among the parties involved, 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 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 below). A reconsideration event occurs when a distribution of equity (or some part thereof) is in excess of accumulated earnings of the legal entity that 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.
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.

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 (see Example 9-7 below).
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. 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 4.3.3), 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, 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. 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.
Section 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)).

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.

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 Section 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

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1 ASC 805-10-20 defines as 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.
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 IPR&D 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 the same amounts at which the assets and liabilities would have been measured had they not been transferred. All other assets (excluding goodwill), liabilities, and noncontrolling interests should be measured in accordance with ASC 805-20-25 and ASC 805-20-30.

10.1.3 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.

ASC 810-10

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)(1) 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 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.

ASU 2014-13 is effective for public business entities for annual periods, and interim periods within those annual periods, beginning after December 15, 2015, and for all other entities in the annual periods ending after December 15, 2016, and interim periods beginning after December 15, 2016. Early adoption is permitted as of the beginning of an annual period.

ASC 810-10-20 defines a collateralized financing entity (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).”
A reporting entity may be required to consolidate CFEs with which it is involved, such as CDOs and CLOs, as a result of ASU 2015-02. If the reporting entity did not early adopt the measurement alternative in ASU 2014-13 for its previously consolidated CFEs, the reporting entity may decide to adopt both ASUs at the same time. See Section 12.2.6 for additional information. Under ASC 810-10-30-16, if the reporting entity does not elect this measurement alternative to the ASC 820 requirements, the reporting entity will reflect any differences between the fair value of a consolidated CFE’s financial assets and financial liabilities in earnings and will attribute these differences to the reporting entity in the consolidated statement of income (loss).

### 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 810-10-45. The primary beneficiary is subject to the reporting and disclosure requirements discussed in Section 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/paid from a consolidated VIE. After elimination, these amounts will not be included in revenue or other income. However, the effect (i.e., the benefit/obligation) of these amounts received/paid from 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 7.5 percent interest rate on the debt.

Tables 10-1 and 10-2 below illustrate the impact on Z’s financial statements of consolidating X under the voting interest entity model and ASC 810-10-35-3, respectively. The differences between the two tables illustrate the effects of allocating eliminations and attributing the effect of the elimination to the primary beneficiary.

<table>
<thead>
<tr>
<th>Table 10-1 — Approach to Intercompany Eliminations Under the Voting Interest Entity Model in ASC 810-10</th>
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<tbody>
<tr>
<td><strong>Z</strong></td>
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<tr>
<td>Sales</td>
</tr>
<tr>
<td>Cost of sales</td>
</tr>
<tr>
<td>Operating margin</td>
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<td>Other income (expense)</td>
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<td>Interest income</td>
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<td>Interest expense</td>
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<tr>
<td>Noncontrolling interest</td>
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<td>Net income</td>
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</tbody>
</table>

Although it does not apply because X is a VIE, 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. Net income attributable to Z would have been reduced by $75.

<table>
<thead>
<tr>
<th>Table 10-2 — Approach to Intercompany Eliminations Under the VIE Model in ASC 810-10</th>
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<tbody>
<tr>
<td><strong>Z</strong></td>
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<td>Sales</td>
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<td>Interest income</td>
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<td>Noncontrolling interest</td>
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<td>Net income</td>
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</table>

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). Enterprise Z’s interest income has been eliminated. However, net income attributable to Z remains unchanged at $2,075. This reflects the fact that Y’s (the noncontrolling interest) legal right to net income is limited to $125.
10.2.2 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.

35-7 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.

35-8 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).

35-9 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).

10.2.3 Acquisition of Noncontrolling Interest

**ASC 810-10**

45-23 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.

45-24 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.
Section 11 — Presentation and Disclosures

11.1 Presentation

ASC 810-10

45-25 A reporting entity shall present each of the following separately on the face of the statement of financial position:

a. Assets of a consolidated variable interest entity (VIE) that can be used only to settle obligations of the consolidated VIE
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.

11.1.1 Separate Presentation Requirements

The variable interest model requires a reporting entity 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, 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, on the basis of recent SEC comment letters, the SEC 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 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 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.
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]
Section 11 — Presentation and Disclosures

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.

45-13 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 Section 7, it is determined that a variable interest holder is the primary beneficiary of a VIE, the VIE will effectively be considered a new subsidiary of the company and should be consolidated in accordance with the guidance in Section 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.

Similarly, under the SEC’s requirements in Regulation S-X, the difference cannot be more than 93 days (see ASC 810-10-S99-2(b)), and the company must disclose (1) the closing date for the subsidiary and (2) the factors supporting the parent’s use of different fiscal-year-end dates. While ASC 810-10 and Regulation S-X do 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 and Regulation S-X, Rule 3A-02, which state 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 independent accountants.

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.

11.1.4 Parent and Subsidiary With Different Fiscal-Year-End Dates — Initial Quarter After Acquisition

In the initial quarter after a registrant acquires a subsidiary whose fiscal-year-end is different from its own, the registrant can use different methods to apply the guidance in ASC 810-10-45-12. However, we are aware that the SEC staff has raised questions regarding the use of these methods. We encourage SEC registrants to preclear the use of any method with the SEC staff before financial statements are filed.
Section 11 — Presentation and Disclosures

Example 11-2

On June 1, a calendar-year-end registrant acquires a subsidiary with a fiscal year ending July 31. The registrant intends to record the subsidiary’s earnings on a one-quarter lag. The registrant’s last quarter-end was June 30, and the subsidiary’s last quarter-end was April 30.

**Method 1**

The registrant would not record any subsidiary earnings in its results for the quarter ended June 30 because the registrant had no rights to the subsidiary’s results for the quarter ended April 30. In the quarter ended September 30, the registrant records the subsidiary’s results for the quarter ended July 31.

**Method 2**

The registrant 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 registrant 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 registrant’s effects of earnings on its equity.

Assume that a subsidiary with a September year-end was acquired on April 1, and the registrant reports on a calendar-year-end basis. The registrant 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, 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 registrant’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.

11.2 **Disclosures**

**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:

- Impact of ASU 2015-02 on disclosures — Section 11.2.1.
- 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 Impact of ASU 2015-02 on Disclosures

ASU 2015-02 did not amend any of the disclosure requirements in ASU 2009-17. However, it added the requirement that a reporting entity provide the following additional disclosures (if applicable):

- Disclosures about certain money market funds that are not within the scope of the VIE guidance (see Section 11.2.5.2).
- The transition disclosures required by ASC 250-10-50-1 and 50-2 (except for the requirement in ASC 250-10-50-1(b)(2)) upon the adoption of ASU 2015-02.

11.2.2 Disclosure Requirements for All Variable Interest Holders, Including the Primary Beneficiary

ASC 810-10

50-5A 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:

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.

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.

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:
   1. The type and amount of support, including situations in which the reporting entity assisted the VIE in obtaining another type of support
   2. The primary reasons for providing the support.

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.

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.
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 partnerships. 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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<tbody>
<tr>
<td>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:</td>
</tr>
<tr>
<td>a. Subparagraph superseded by Accounting Standards Update No. 2009-17</td>
</tr>
<tr>
<td>b. Subparagraph superseded by Accounting Standards Update No. 2009-17</td>
</tr>
<tr>
<td>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.</td>
</tr>
<tr>
<td>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</td>
</tr>
<tr>
<td>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.</td>
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</table>

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.

In addition to those discussed in Section 11.2.2, a primary beneficiary must provide the above disclosures 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, and (3) its assets can be used other than for the settlement of the VIE’s obligations.

If the VIE meets the definition of a business, the primary beneficiary also should provide the disclosures required by ASC 805. 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.

11.2.4 Disclosure Requirements for Only Variable Interest Holders Other Than the Primary Beneficiary

<table>
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<tr>
<th>ASC 810-10</th>
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<tbody>
<tr>
<td>50-4 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>
</tbody>
</table>
Section 11 — Presentation and Disclosures

ASC 810-10 (continued)

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.

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.

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.

In addition to those discussed in Section 11.2.2, a variable interest holder that is not the primary beneficiary of a VIE must provide the above disclosures.

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

ASC 810-10

50-6 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.

11.2.6 Other Disclosure Considerations

11.2.6.1 Aggregation of Disclosures

<table>
<thead>
<tr>
<th>ASC 810-10</th>
</tr>
</thead>
</table>
| **50-9** Disclosures about VIEs may be reported in the aggregate for similar entities if separate reporting would not provide more useful information to financial statement users. A reporting entity shall disclose how similar entities are aggregated and shall distinguish between:

<p>| |</p>
<table>
<thead>
<tr>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>a. VIEs that are not consolidated because the reporting entity is not the primary beneficiary but has a variable interest</td>
</tr>
<tr>
<td>b. VIEs that are consolidated.</td>
</tr>
</tbody>
</table>

In determining whether to aggregate VIEs, the reporting entity shall consider quantitative and qualitative information about the different risk and reward characteristics of each VIE and the significance of each VIE to the entity. The disclosures shall be presented in a manner that clearly explains to financial statement users the nature and extent of an entity’s involvement with VIEs.

| **50-10** A reporting entity shall determine, in light of the facts and circumstances, how much detail it shall provide to satisfy the requirements of the Variable Interest Entities Subsections. A reporting entity shall also determine how it aggregates information to display its overall involvements with VIEs with different risk characteristics. The reporting entity must strike a balance between obscuring important information as a result of too much aggregation and overburdening financial statements with excessive detail that may not assist financial statement users to understand the reporting entity’s financial position. For example, a reporting entity shall not obscure important information by including it with a large amount of insignificant detail. Similarly, a reporting entity shall not disclose information that is so aggregated that it obscures important differences between the types of involvement or associated risks. |

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.
Section 12 — ASU 2015-02’s Effective Date and Transition Guidance

12.1 Introduction and Effective Date

The following represents the transition and effective date information related to Accounting Standards Update No. 2015-02, Consolidation (Topic 810): Amendments to the Consolidation Analysis:

a. The pending content that links to this paragraph shall be effective as follows:
   1. For public business entities, for fiscal years, and for interim periods within those fiscal years, beginning after December 15, 2015.
   2. For all other entities, for fiscal years beginning after December 15, 2016, and for interim periods within fiscal years beginning after December 15, 2017.

b. If a reporting entity is required to consolidate a legal entity as a result of the initial application of the pending content that links to this paragraph, the initial measurement of the assets, liabilities, and noncontrolling interests of the legal entity depends on whether the determination of their carrying amounts is practicable. In this context, carrying amounts refers to the amounts at which the assets, liabilities, and noncontrolling interests would have been carried in the consolidated financial statements if the requirements of the pending content that links to this paragraph had been effective when the reporting entity first met the conditions to consolidate the legal entity.
   1. If determining the carrying amounts is practicable, the reporting entity shall initially measure the assets, liabilities, and noncontrolling interests of the legal entity at their carrying amounts at the date the pending content that links to this paragraph first applies.
   2. If determining the carrying amounts is not practicable, the assets, liabilities, and noncontrolling interests of the legal entity shall be measured at fair value at the date the pending content that links to this paragraph first applies.

c. Any difference between the net amount added to the statement of financial position of the reporting entity and the amount of any previously recognized interest in the newly consolidated legal entity shall be recognized as a cumulative-effect adjustment to retained earnings. A reporting entity shall describe the transition method(s) applied and shall disclose the amount and classification in its statement of financial position of the consolidated assets or liabilities by the transition method(s) applied.

d. A reporting entity that is required to consolidate a legal entity as a result of the initial application of the pending content that links to this paragraph may elect the fair value option provided by the Fair Value Option Subsections of Subtopic 825-10 on financial instruments, but only if the reporting entity elects the option for all financial assets and financial liabilities of that legal entity that are eligible for this option under those Fair Value Option Subsections. This election shall be made on a legal entity-by-legal entity basis. Along with the disclosures required in those Fair Value Option Subsections, the reporting entity shall disclose all of the following:
   1. Management’s reasons for electing the fair value option for a particular legal entity or group of legal entities.
   2. The reasons for different elections if the fair value option is elected for some legal entities and not others.
   3. Quantitative information by line item in the statement of financial position indicating the related effect on the cumulative-effect adjustment to retained earnings of electing the fair value option for a legal entity.

e. If a reporting entity is required to deconsolidate a legal entity as a result of the initial application of the pending content that links to this paragraph, the initial measurement of any retained interest in the deconsolidated former subsidiary depends on whether the determination of its carrying amount is practicable. In this context, carrying amount refers to the amount at which any retained interest would have been carried in the reporting entity’s financial statements if the pending content that links to this paragraph had been effective when the reporting entity became involved with the legal entity or no longer met the conditions to consolidate the legal entity.
Section 12 — ASU 2015-02’s Effective Date and Transition Guidance

ASC 810-10 (continued)

1. If determining the carrying amount is practicable, the reporting entity shall initially measure any retained interest in the deconsolidated former subsidiary at its carrying amount at the date the pending content that links to this paragraph first applies.

2. If determining the carrying amount is not practicable, any retained interest in the deconsolidated former subsidiary shall be measured at fair value at the date the pending content that links to this paragraph first applies.

f. Any difference between the net amount removed from the statement of financial position of the reporting entity and the amount of any retained interest in the newly deconsolidated legal entity shall be recognized as a cumulative-effect adjustment to retained earnings. A reporting entity shall disclose the amount of any cumulative-effect adjustment related to deconsolidation separately from any cumulative-effect adjustment related to consolidation of entities.

g. The determinations of whether a legal entity is a variable interest entity (VIE) and which reporting entity, if any, should consolidate the legal entity shall be made as of the date the reporting entity became involved with the legal entity or, if events have occurred requiring reconsideration of whether the legal entity is a VIE and which reporting entity, if any, should consolidate the legal entity, as of the most recent date at which the pending content that links to this paragraph would have required consideration.

h. If, at transition, it is not practicable for a reporting entity to obtain the information necessary to make the determinations in (g) as of the date the reporting entity became involved with a legal entity or at the most recent reconsideration date, the reporting entity shall make the determinations as of the date on which the pending content that links to this paragraph is first applied.

i. If the determinations of whether a legal entity is a VIE and whether a reporting entity should consolidate the legal entity are made in accordance with (h), then the consolidating entity shall measure the assets, liabilities, and noncontrolling interests of the legal entity at fair value as of the date on which the pending content that links to this paragraph is first applied.

j. The pending content that links to this paragraph may be applied retrospectively in previously issued financial statements for one or more years with a cumulative-effect adjustment to retained earnings as of the beginning of the first year restated.

k. Early adoption, including adoption in an interim period, of the pending content that links to this paragraph is permitted. If an entity early adopts the pending content that links to this paragraph in an interim period, any adjustments (see paragraph 810-10-65-7(b) through (i)) shall be reflected as of the beginning of the fiscal year that includes that interim period.

l. An entity shall provide the disclosures in paragraphs 250-10-50-1 through 50-2 (with the exception of the disclosure in paragraph 250-10-50-1(b)(2)) in the period the entity adopts the pending content that links to this paragraph.

For public business entities, the guidance in ASU 2015-02 is effective for annual periods, and interim periods within those annual periods, beginning after December 15, 2015. For entities other than public business entities, the guidance is effective for annual periods beginning after December 15, 2016, and interim periods beginning after December 15, 2017. Early adoption is allowed for all entities (including during an interim period), but the guidance must be applied as of the beginning of the annual period containing the adoption date. Entities have the option of using either a full retrospective or a modified retrospective adoption approach. In addition, the ASU provides a practicability exception for determining the carrying value of the retained interest in a legal entity when the reporting entity is required to deconsolidate the legal entity as a result of adopting the guidance. A reporting entity that qualifies for the practicability exception will be allowed to use fair value to initially measure its retained interest.

A reporting entity may decide to adopt the ASU for its year-end (e.g., December 31, 2015) SEC Form 10-K. In this situation, the ASU allows a reporting entity to adopt the revised requirements in its fourth quarter (ending December 31, 2015) if the reporting entity does so as of the beginning of the annual period. Accordingly, the statement of operations for the fourth quarter would reflect the reporting entity’s results as though it had adopted the revised requirements at the beginning of the year (January 1, 2015). Reporting entities should consider whether they would be required to revise the information in their prior-quarter filings if, for example, they are undergoing the registration process.

12.2 Transition

ASC 810-10, as amended by ASU 2015-02, requires that upon adoption of the ASU, a reporting entity should determine whether a legal entity is a VIE and whether the reporting entity is the VIE’s primary beneficiary, as of the
date the reporting entity first became involved with the legal entity, unless an event requiring reconsideration of those initial conclusions occurred after that date (see Section 9 for a discussion of reconsideration events). When making this determination, a reporting entity must assume that ASU 2015-02 had been effective since the date of its first involvement with the entity.

12.2.1 Transition Options
A reporting entity may apply the ASU’s amendments by using a full retrospective or a modified retrospective approach. Under a full retrospective approach, the reporting entity would retrospectively apply the ASU to one or more years presented in its financial statements and record a cumulative-effect adjustment to retained earnings as of the beginning of the first year presented. Under a modified retrospective approach, the reporting entity would record a cumulative-effect adjustment to equity as of the beginning of the period of adoption. In selecting a transition option, a reporting entity should consider, among other factors, the effort required to recast previous periods and the impact on the financial statements presented.

12.2.2 Initial Measurement Upon Consolidation
If a reporting entity is required to consolidate a legal entity as a result of the initial application of the ASU, the initial measurement of the assets, liabilities, and noncontrolling interests of the legal entity depends on whether the determination of their carrying amounts is practicable. If amounts can be practicably determined, the reporting entity should initially measure and recognize all assets, liabilities, and noncontrolling interests of the VIE at their carrying amounts on the date of adoption. In this context, carrying amounts refer to the amounts at which the assets, liabilities, and noncontrolling interests would have been carried in the consolidated financial statements if the requirements of the ASU had been effective when the reporting entity first met the conditions to consolidate the legal entity. The ASU does not change the guidance under ASC 810-10-30 regarding initial measurement of a newly consolidated legal entity’s assets, liabilities, and noncontrolling interests (see Section 10).

12.2.3 Practicability Exceptions Regarding Initial Measurement
The ASU provides practicability exceptions to the requirements for applying the transition provisions related to both (1) recognition and (2) initial measurement. It is not always practicable for a reporting entity to determine whether a legal entity would have been a VIE or if and when, on the basis of whether reconsideration events have occurred, the reporting entity may have been the primary beneficiary if the ASU’s provisions had always been effective. In addition, there also may be situations in which it is not practicable to determine carrying amounts.

If, at transition, it is not practicable for a reporting entity to obtain the information necessary to determine, as of the date the reporting entity became involved with a legal entity or as of the most recent reconsideration date, (1) whether the legal entity is a VIE and (2) whether the reporting entity is the primary beneficiary, the reporting entity would make those determinations as of the date on which the reporting entity first applies the ASU (i.e., the effective date of the ASU). Under this exception, instead of applying this guidance to the date of initial involvement, or when the most recent reconsideration event occurred, the reporting entity will only perform the VIE and primary-beneficiary analysis as of the date of adoption of the ASU.

In a manner similar to the exception discussed above for recognition, if determining the carrying amount of assets, liabilities, and noncontrolling interest of the legal entity is not practicable, the reporting entity is permitted to measure the assets, liabilities, and noncontrolling interests of the legal entity at fair value. Any difference between the net amount added to the statement of financial position of the reporting entity and the amount of any previously recognized interest in the newly consolidated legal entity would be recognized as a cumulative-effect adjustment to retained earnings.

Under the VIE model, “involvement with a legal entity refers to ownership, contractual, or other pecuniary interests that may be determined to be variable interests.”
The ASU requires a reporting entity to describe the transition method(s) applied and disclose the amount and classification in its statement of financial position of the consolidated assets or liabilities by the transition method(s) applied.

When assessing whether it can use the practicability exception, the reporting entity should exercise judgment and consider all facts and circumstances, including but not limited to whether the data is available or could be recreated from information readily obtainable and whether the reporting entity can value the assets, liabilities, and noncontrolling interests as of the initial date of assessment without placing undue emphasis on hindsight.

12.2.4 Electing the Fair Value Option Upon Consolidation

ASC 810-10-65-7(d) permits a reporting entity that consolidates a legal entity as a result of the initial application of the ASU to elect the fair value option (FVO) under the subsections in ASC 825-10 on the FVO for financial instruments. This election may only be applied if the reporting entity elects the FVO for all the financial assets and financial liabilities of that legal entity that are eligible for the FVO. A reporting entity must make the election on a legal-entity-by-legal-entity basis.

A reporting entity that elects the FVO must disclose, in addition to the disclosure requirements in the FVO subsections in ASC 825, all of the following:

- Management’s reasons for electing the FVO for a particular legal entity or group of legal entities.
- The reasons for different elections if the FVO is elected for some legal entities and not others.
- Quantitative information by line item in the statement of financial position indicating the related effect on the cumulative-effect adjustment to retained earnings of electing the FVO for a legal entity.

12.2.5 Approach to Transition

When determining the impact of transition (under either the full retrospective or modified retrospective approach), a reporting entity must assume that the ASU had been effective from the date of its first involvement with the legal entity, unless an event requiring reconsideration of those initial conclusions occurred after that date, or that the reporting entity is using the practicability exception described in Section 12.2.3.

The steps the reporting entity would take in making this determination are as follows:

- **Step 1** — The reporting entity should identify the legal entities (both VIEs and non-VIEs) that it is involved with as of the adoption date of the ASU (i.e., the beginning of the reporting entity’s fiscal year for a reporting entity early adopting) and the date it first became involved with those entities.
- **Step 2** — The reporting entity should determine for each legal entity whether any reconsideration events pursuant to ASC 810-10-35-4 have occurred that would have resulted in a change to the legal entity’s VIE status (e.g., a legal entity would have become a VIE or would no longer have been a VIE) after the date identified in step 1. If so, the date of that reconsideration event is the date the reporting entity uses to determine the entity’s VIE status. If not, the date identified in step 1 is used to identify whether it is the primary beneficiary of the legal entity.
- **Step 3** — The reporting entity should determine for each legal entity whether any changes in facts and circumstances have occurred that would have changed the primary-beneficiary conclusion under the VIE model in ASC 810-10, as amended by the ASU, after the date identified in step 2. If so, the date of the change in facts and circumstances is the date the reporting entity uses to determine whether it is the primary beneficiary of the VIE. If not, the reporting entity uses the date identified in step 2 to determine whether it is the primary beneficiary of the legal entity.

If, after applying the guidance in steps 1–3 to a legal entity, a reporting entity reaches the same consolidation conclusion for the legal entity as the conclusion that was reflected in the reporting entity’s financial statements
before the adoption of the ASU (i.e., if the initial adoption of the ASU does not result in the consolidation of a previously unconsolidated legal entity or the deconsolidation of a previously consolidated legal entity), the reporting entity would not need to perform the remaining step (step 4) of this analysis for that legal entity. However, the reporting entity would need to assess the disclosure requirements in the VIE subtopics of ASC 810-10 if that legal entity is a VIE as of the adoption date and the reporting entity holds a variable interest.

If, after applying the guidance in steps 1–3 to a legal entity, a reporting entity reaches a consolidation conclusion that is different from its consolidation conclusion for that legal entity before the adoption of the ASU (i.e., if the initial adoption of the ASU results in consolidation of a previously unconsolidated legal entity or deconsolidation of a previously consolidated legal entity as of the adoption date), the reporting entity must, under ASC 810-10-30-8 through 30-8D and ASC 810-10-65-7, measure the components of that newly consolidated legal entity or any retained interest in that newly deconsolidated legal entity at their carrying amounts as of the adoption date. To determine carrying amounts for newly consolidated or deconsolidated legal entities, a reporting entity will need to proceed to the next step:

- **Step 4** — A reporting entity must determine the amounts of the assets, liabilities, and noncontrolling interests of the newly consolidated legal entity, or the amount of any retained interests in the newly deconsolidated legal entity, that would have been recorded in the reporting entity’s financial statements as of the adoption date, as if the ASU had been effective as of the date of the reporting entity’s initial involvement with the legal entity or the most recent date on which the primary-beneficiary conclusion would have changed (i.e., the same primary-beneficiary date identified in step 3 above). These amounts are the carrying amounts referred to in the ASU. Any difference between the net amount added (for consolidating reporting entities) or removed (for deconsolidating reporting entities) from the reporting entity’s balance sheet and the amount of any previously recognized interest or retained interest is recognized as a cumulative-effect adjustment to retained earnings.

Note that the ASU indicates that if, at transition, it is not practicable for a reporting entity to obtain the information it needs to make the determinations in steps 2 and 3 above, the reporting entity should make those determinations on the date that the ASU is first applied. In such cases, the primary beneficiary would be required to measure the elements of the VIE at fair value as of the adoption date. See Section 12.2.3 for further considerations related to these exceptions. In addition, ASC 810-10-65-7 provides guidance on a reporting entity’s ability to elect the FVO when it is required to consolidate a legal entity as a result of the initial adoption of the ASU. The examples below illustrate the application of steps 1–4 above.

### Example 12-1

Entity A initially became involved with Entity X by acquiring a variable interest in X (a VIE) on March 1, 2009. Before adopting ASU 2015-02, A was the primary beneficiary and therefore consolidated X under ASC 810 (i.e., A consolidated X as of December 31, 2015).

Since the date of its initial involvement with X, various changes in facts and circumstances have occurred that would have required reconsideration of A’s consolidation analysis under the ASU. Upon adopting the ASU, A determines that X was a VIE as of March 1, 2009 (i.e., the date A first became involved with X). Although reconsideration events under ASC 810-10-35-4(a)–(e) have occurred since the date of A’s initial involvement with X, none of those reconsideration events would have changed X’s VIE status; thus, the date of initial involvement is used to determine X’s VIE status. Entity A also made the following determinations regarding its primary-beneficiary status:

<table>
<thead>
<tr>
<th>Event</th>
<th>Date</th>
<th>VIE and Primary-Beneficiary Status Under ASU 2015-02</th>
</tr>
</thead>
<tbody>
<tr>
<td>Date of first involvement with entity</td>
<td>March 1, 2009</td>
<td>VIE/primary beneficiary</td>
</tr>
<tr>
<td>Change in facts and circumstances and ASC 810-10-35-4(a)–(e) reconsideration events</td>
<td>September 15, 2011</td>
<td>VIE/not primary beneficiary</td>
</tr>
<tr>
<td>Adoption date of ASU 2015-02</td>
<td>January 1, 2016</td>
<td>VIE/not primary beneficiary</td>
</tr>
</tbody>
</table>
Example 12-1 (continued)

The initial measurement of A’s retained interest in the VIE would occur as of September 15, 2011, because that was the most recent date on which a change in facts and circumstances would have affected A’s primary-beneficiary conclusion had the provisions of the ASU been effective (the VIE conclusion did not change and therefore has no effect on the analysis). Entity A would then need to adjust that amount on the basis of how it would have accounted for its retained interest in X if X had not been consolidated from September 15, 2011, through the adoption date of the ASU (which, in this example, is January 1, 2016). That adjusted amount (the carrying amount) would be recorded in A’s financial statements as of January 1, 2016. Any difference between that amount and the amounts derecognized from the balance sheet would be recognized as a cumulative-effect adjustment to retained earnings.

Example 12-2

Entity A is a calendar-year-end entity that initially became involved with Entity X by acquiring a variable interest in X (a VIE) on March 1, 2008. Assume that before adopting ASU 2015-02, A was not the primary beneficiary and therefore did not consolidate X under ASC 810 (i.e., A did not consolidate X as of December 31, 2015).

Since the date of its initial involvement with X, various changes in facts and circumstances have occurred that would have required reconsideration of A’s consolidation analysis under the ASU. Upon adopting the ASU, A determines that X was a VIE as of September 15, 2011 (i.e., the most recent date on which a VIE reconsideration event under ASC 810-10-35-4(a)–(e) occurred and the entity’s VIE status changed). Entity A also made the following determinations regarding its primary-beneficiary status:

<table>
<thead>
<tr>
<th>Event</th>
<th>Date</th>
<th>VIE and Primary-Beneficiary Status Under ASU 2015-02</th>
</tr>
</thead>
<tbody>
<tr>
<td>Date of first involvement with entity</td>
<td>March 1, 2008</td>
<td>VIE/primary beneficiary</td>
</tr>
<tr>
<td>Change in facts and circumstances and ASC 810-10-35-4(a)–(e) VIE reconsideration event</td>
<td>July 15, 2010</td>
<td>Not VIE/not primary beneficiary</td>
</tr>
<tr>
<td>Change in facts and circumstances and ASC 810-10-35-4(a)–(e) VIE reconsideration event</td>
<td>September 15, 2011</td>
<td>VIE/primary beneficiary</td>
</tr>
<tr>
<td>Adoption date of ASU 2015-02</td>
<td>January 1, 2016</td>
<td>VIE/primary beneficiary</td>
</tr>
</tbody>
</table>

The initial measurement of the carrying amounts of the VIE would occur as of September 15, 2011, because that was the most recent date on which a change in facts and circumstances would have affected A’s primary-beneficiary conclusions had the provisions of the ASU been effective. Entity A would then need to adjust those amounts as if X had been a consolidated entity from September 15, 2011, through the adoption date of the ASU (which, in this example, is January 1, 2016). Those adjusted amounts (the carrying amounts) would be recorded in A’s financial statements as of January 1, 2016. Any difference between the amounts added to the balance sheet and the amount of any previously recognized interest related to X would be recognized as a cumulative-effect adjustment to retained earnings.

12.2.6 Early Adopting the Guidance in Both ASU 2014-13 and ASU 2015-02

Reporting entities may be required to consolidate CFEs with which they are involved, such as CDOs and CLOs. ASU 2014-13 gives entities that consolidate a CFE an optional practicability exception to applying the fair value measurement guidance in ASC 820 when all of the financial assets and financial liabilities of the consolidated CFE are measured at fair value through net income under other GAAP (e.g., when the entity had elected the FVO for all of the CFE’s financial assets and financial liabilities).

If the reporting entity did not previously early adopt the measurement alternative in ASU 2014-13 for its consolidated CFEs, the reporting entity may decide to adopt both ASU 2014-13 and ASU 2015-02 at the same time. In addition, both ASUs allow public and nonpublic business entities to early adopt the guidance in any quarter during an annual period. However, if the adoption occurs during an interim period other than the first quarter, both ASUs require the reporting entity to reflect the transition as though the guidance had been adopted at the beginning of the annual period.
12.2.7 Initial Measurement Upon Deconsolidation

If a reporting entity is required to deconsolidate a legal entity as a result of the initial application of ASU 2015-02, the initial measurement of any retained interest in the deconsolidated former subsidiary also depends on whether the determination of its carrying amount is practicable.

If a reporting entity is required to deconsolidate a legal entity and it is not impracticable to determine the amounts (see Section 12.2.3), the reporting entity must initially measure the carrying value of any retained interests in the deconsolidated subsidiary on the basis of the amount that would have been reflected in the reporting entity’s financial statements as if ASU 2015-02 had been effective when the reporting entity first became involved with the legal entity. Any differences between the new amount removed from the balance sheet of the deconsolidating legal entity and the amount of any retained interest in the deconsolidated legal entity should be recognized as a cumulative-effect adjustment to retained earnings. The amount of any cumulative-effect adjustment related to deconsolidation should be disclosed separately from the cumulative-effect adjustments related to consolidation.

12.2.8 Deconsolidation of Assets Previously Transferred

If the assets in the previously consolidated legal entity were originally transferred to the legal entity from the reporting entity (rather than acquired by the legal entity in the market), the reporting entity would be required to apply the requirements in ASC 860 or ASC 360-20 to determine the amounts recognized upon the adoption of the guidance in ASU 2015-02. That is, if the reporting entity had not consolidated the legal entity when it originally transferred the assets to the legal entity, the reporting entity would have been required to apply the requirements in ASC 860 or ASC 360-20 to determine whether it could derecognize the assets. Consequently, these requirements would need to be considered under both the modified retrospective and full retrospective transition alternatives in ASU 2015-02.

In addition, although the transition provisions in ASC 810-10-65-7(e) contain a practicability exception for reporting entities that are not able to determine the carrying amount of a retained interest in a deconsolidated former subsidiary, the exception applies only to the measurement of the retained interest. It does not eliminate the requirement to determine whether an asset should be derecognized upon transition.

Furthermore, a reporting entity must also disclose the amount of any cumulative-effect adjustment related to deconsolidation separately from any cumulative-effect adjustment related to consolidation of entities.

Example 12-3

On January 1, 2014, Entity X established Entity Y, a VIE, to purchase commercial loans originated by X and to sell senior and subordinated beneficial interests in those loans. Entity X controls the rights to service and manage the loans owned by Y and receives a fixed fee and a performance fee (the "decision-maker fees") as consideration for performing such activities.

Before the adoption of ASU 2015-02, X concluded that its decision-maker fees represented variable interests. Entity X also concluded that it was the primary beneficiary of Y because it had:
- The power over the activities that most significantly affected the economic performance of Y (i.e., servicing and managing the commercial loans).
- A significant economic interest. Its subordinated decision-maker fees exposed it to variability that could potentially be significant to Y.

Entity X determines that if the requirements in ASU 2015-02 had been effective as of January 1, 2014 (i.e., the date X became involved with Y), X would never have been the primary beneficiary of Y. It reached this conclusion because the decision-maker fees do not qualify as a variable interest under ASC 810-10-55-37 (as amended by ASU 2015-02).

Entity X originated commercial loans and sold them to Y throughout the year. Accordingly, X must evaluate whether the loans that it originated and sold to Y would have qualified for derecognition under ASC 860 if it were not consolidating Y. Although X concluded that under the ASU, Y would never have been consolidated, to derecognize the loans it originated and transferred to Y, X would need to evaluate whether the transfer meets the derecognition requirements in ASC 860.
12.2.8.1 Electing the FVO on a Retained Interest Upon Deconsolidation

When a legal entity is deconsolidated (upon adoption of ASU 2015-02 or subsequently), a reporting entity may also elect the FVO for its retained interest in a newly deconsolidated legal entity. While the FVO 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.

12.3 Additional Transition Considerations for SEC Registrants

12.3.1 Transition Requirements for SEC Registrants

If a registrant early adopts ASU 2015-02 (i.e., in its second quarter ended June 30, 2015), its statement of operations and statement of cash flows for the quarter (and six-month period) ended June 30, 2015, would reflect its results as though it had adopted the revised requirements at the beginning of the year (January 1, 2015). In addition, the selected quarterly information included in the company’s December 31, 2015, Form 10-K, that is required under SEC Regulation S-X, Rule 3-02, would contain the company’s quarterly results as though it had adopted the revised requirements at the beginning of the year.

Example 12-4

An investment manager that is the collateral manager of a CLO has historically consolidated the CLO because it has a potentially significant interest in the VIE through its subordinated performance-based fee. The investment manager has determined that it no longer has a variable interest in the CLO when it adopts ASU 2015-02 because it does not have any other interests in the entity (including interests held by its related parties), and all of the criteria in ASC 810-10-55-37 are met. Accordingly, the investment manager has determined that it will deconsolidate the CLO when it adopts the ASU in the second quarter.

Before Adoption of ASU 2015-02 (First Quarter Form 10-Q)

The investment manager included the CLO’s assets of $104 and liabilities of $102 in its March 31, 2015, consolidated balance sheet in its Form 10-Q:

<table>
<thead>
<tr>
<th>Before Adoption of the ASU</th>
<th>December 31, 2014</th>
<th>March 31, 2015</th>
</tr>
</thead>
<tbody>
<tr>
<td>Consolidated CLO assets</td>
<td>$   100</td>
<td>$   104</td>
</tr>
<tr>
<td>Consolidated CLO liabilities</td>
<td></td>
<td>99</td>
</tr>
<tr>
<td>Appropriate retained earnings</td>
<td></td>
<td>1</td>
</tr>
</tbody>
</table>

It also presented the following in its consolidated income statement for the three months ended March 31, 2015 (for simplicity, income taxes are ignored):

<table>
<thead>
<tr>
<th>Three Months Ended March 31, 2015</th>
<th>Net income</th>
<th>Less: Net income attributable to noncontrolling interests and other interests held by third parties</th>
<th>Net income attributable to parent</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>$72*</td>
<td></td>
<td>$71</td>
</tr>
</tbody>
</table>

* Consolidated net income consists of the investment manager’s unconsolidated net income of $71 for the period and $1 related to change in fair value of the assets and liabilities of the consolidated CLO, which are recognized at fair value through earnings.
Example 12-4 (continued)

After Adoption of ASU 2015-02 (Second Quarter Form 10-Q)

The investment manager would not include any of the CLO’s assets or liabilities in its June 30, 2015, consolidated balance sheet since it is no longer required to consolidate the CLO. However, because the investment manager elected to apply the modified retrospective transition approach (as discussed in Section 12.2.1), it would still include the assets and liabilities of the consolidated CLO in the December 31, 2014, balance sheet (comparative amounts) in its second quarter Form 10-Q.

The investment manager would present the following on the face of its consolidated income statement for the three and six months ended June 30, 2015 (for simplicity, income taxes are ignored):

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Net income</td>
<td>$25</td>
<td>$96*</td>
</tr>
<tr>
<td>Less: Net income attributable to noncontrolling interests and other interests held by third parties</td>
<td>0</td>
<td>0</td>
</tr>
<tr>
<td>Net income attributable to parent</td>
<td>$25</td>
<td>$96</td>
</tr>
</tbody>
</table>

* The six-month net income amount includes the investment manager parent’s net income of $71 for the first quarter and $25 for the second quarter.

12.3.2 Filing Considerations for SEC Registrants — Modified Retrospective Application

If an SEC registrant uses the modified retrospective approach to adopt the guidance in ASU 2015-02 during a quarter after the first quarter of its fiscal year (e.g., its second quarter ending June 30, 2015), the registrant would not be required to amend its Form(s) 10-K or Form(s) 10-Q filed for the periods before its adoption of the ASU. Since the prior reports were not incorrect when filed, the registrant should not file a Form 10-K/A or Form 10-Q/A.

However, the registrant should consult with legal counsel to determine whether it is required to file a Form 8-K or include updated amounts if it subsequently files a new registration statement or amends a current one. The registrant should consider the following guidelines:

- If it does not file a new registration statement or amend a current one, the registrant would generally not be required to file a Form 8-K.
- If it is in the process of filing a new registration statement or amending a current one (other than on Form S-8), the registrant would need to consider whether it must revise its previously filed quarterly information. If the effects of adopting the ASU are deemed material to the previously filed financial information, the registrant may need to file a Form 8-K with the updated information (or include the updated information in the registration statement itself). Even if the effects of adopting the ASU are not deemed material to the previously filed financial information, additional disclosures may still be needed.

For a Form S-8 registration statement, a registrant must determine whether the effects of adopting the ASU would be considered a “material change in the registrant’s affairs.”

12.3.3 Filing Considerations for SEC Registrants — Consolidation

We do not believe that an SEC registrant that must consolidate a previously unconsolidated legal entity (or deconsolidate a previously consolidated legal entity) as a result of adopting ASU 2015-02 would need to provide the information required under Form 8-K, Item 2.01, or under SEC Regulation S-X, Rule 3-05. Under Item 2.01, a registrant is required to provide additional information when it has completed the acquisition or disposition of a significant amount of assets other than in the ordinary course of business. However, it is our understanding that the SEC staff would not object if an entity does not apply the guidance in Item 2.01 for a change in its consolidation conclusion solely as a result of adopting ASU 2015-02. Accordingly, an entity would also not be required to provide separate financial statements under the requirements in Rule 3-05. Registrants should refer to the highlights of the March 2015 CAQ SEC Regulations Committee joint meeting with the SEC staff, at which this topic was discussed.
12.3.4 Filing Considerations for SEC Registrants — Deconsolidation

We believe that if an SEC registrant must deconsolidate a legal entity as a result of adopting ASU 2015-02, the registrant would be required to provide the disclosures in SEC Regulation S-X, Rule 3-09, and SEC Regulation S-X, Rule 4-08(g), for investments that are subsequently accounted for under the equity method of accounting. Although a registrant may no longer be required to consolidate a legal entity after the adoption of the ASU, it would need to provide the disclosures in Rules 3-09 and 4-08(g) for any equity method investee that meets the significance thresholds. These disclosures would be required in addition to those in ASC 323 for equity method investees.
Appendix A — Comparison of Consolidation Requirements Under ASU 2009-17 and ASU 2015-02

This appendix compares the consolidation requirements after the application of (1) ASU 2009-17 and (2) ASU 2015-02. It also outlines the potential impact of the changes.

<table>
<thead>
<tr>
<th>Subject</th>
<th>Under ASU 2009-17</th>
<th>Under ASU 2015-02</th>
<th>Potential Impact of Changes</th>
</tr>
</thead>
<tbody>
<tr>
<td>Decision-maker or service-provider fee arrangements</td>
<td>A fee arrangement is considered a variable interest in a legal entity unless various criteria are met. In addition, a decision maker or service provider is required to consider all fees when evaluating its economic exposure to a VIE.</td>
<td>Fees paid to a decision maker that are “at market” and are commensurate with the services provided are generally (1) not in and of themselves considered variable interests and (2) excluded from the assessment of the decision maker’s or service provider’s economic exposure to a VIE.</td>
<td>Fewer fee arrangements will be considered variable interests. Consequently, legal entities in which the decision maker is considered to be acting in an agency capacity on behalf of the equity holders (i.e., the decision maker does not have a variable interest) could potentially no longer be considered VIEs. In addition, because most fees will be excluded from the evaluation of a decision maker’s economic exposure to a VIE, certain structures will not be consolidated.</td>
</tr>
<tr>
<td>Determining whether a limited partnership (or similar entity) is a VIE</td>
<td>A limited partnership is a VIE if it meets any of the conditions in ASC 810-10-15-14. In the evaluation of whether a limited partnership is a VIE, kick-out and participating rights are only considered if held by a single limited partner (including its related parties).</td>
<td>A limited partnership is a VIE unless a simple majority or lower threshold (including a single limited partner) of all limited partners unrelated to the general partner have substantive kick-out or participating rights.</td>
<td>Limited partnership arrangements that include simple majority kick-out or participating rights may no longer be VIEs. Conversely, limited partnerships that do not include such rights would need to be evaluated for consolidation under the VIE guidance, even if the general partner was historically considered part of the equity group.</td>
</tr>
<tr>
<td>Determining whether an entity other than a limited partnership is a VIE</td>
<td>If the equity holders as a group do not have power (i.e., the power rests with a decision maker that is not considered part of the equity group), the evaluation would focus on whether (1) a single equity holder has the unilateral ability to remove the decision maker or participate in the activities that most significantly affect the entity’s economic performance or (2) the decision maker is acting as an agent.</td>
<td>Determining whether the equity group has power is a two-step process. The reporting entity first needs to determine whether the equity holders have power over the most significant activities of a legal entity through their equity interests. If the equity holders as a group do not have power, the evaluation would be performed in a manner consistent with current requirements.</td>
<td>Because of the requirement to first evaluate whether the equity group has power through its equity interests, more legal entities could be VIEs.</td>
</tr>
<tr>
<td>Subject</td>
<td>Under ASU 2009-17</td>
<td>Under ASU 2015-02</td>
<td>Potential Impact of Changes</td>
</tr>
<tr>
<td>------------------------------------------------------------------------</td>
<td>-----------------------------------------------------------------------------------</td>
<td>-----------------------------------------------------------------------------------</td>
<td>--------------------------------------------------------------------------------------------</td>
</tr>
</tbody>
</table>
| Determining whether a general partner consolidates a limited partnership (or similar entity) that is not a VIE | A general partner is presumed to control a limited partnership that is not a VIE unless a simple majority of the limited partners (excluding the general partner’s related parties) have either of the following:  
  • The substantive ability to dissolve the limited partnership or otherwise remove the general partner without cause.  
  • Substantive participating rights (ASC 810-20).  
The general partner’s economic exposure is not considered in the evaluation. | A general partner would not consolidate a limited partnership that is not a VIE. Rather, an individual limited partner would be required to consolidate the partnership if the limited partner has the substantive ability to dissolve the partnership or otherwise remove the general partner without cause (as distinguished from with cause). If the limited partner does not have such ability, or the other limited partners have substantive participating rights, the limited partner is not required to consolidate the partnership. | More partnerships may be VIEs as a result of the requirement to consider if substantive rights exist in the evaluation of whether a partnership is a VIE. However, because the general partner must consider its economic interest (excluding fees that are “at market” and commensurate with the services) in the VIE under the VIE consolidation analysis, partnerships that were consolidated under ASC 810-20 may be deconsolidated. By contrast, a limited partner may be required to consolidate a partnership that is not a VIE (i.e., if it has a simple majority of the substantive removal rights). |
| Interests held by a reporting entity’s related parties (including de facto agents) | A decision maker is required to consider the interests of its related parties (except, generally, employees and employee benefit plans) in a VIE as its own when evaluating whether its fee arrangement represents a variable interest. | A decision maker should consider its direct interests in a VIE together with its indirect exposure through its related parties (except, generally, employees and employee benefit plans) on a proportionate basis when evaluating whether it is required to consolidate a VIE, unless the related party is under common control. In addition, a decision maker would include the entire interest held by its related parties under common control in the evaluation of whether its fee arrangement is a variable interest if it has an interest in the related party or the interest was provided to the related party under common control to circumvent the consolidation guidance. | Because a decision maker considers only a pro rata portion of the interests held by its related parties that are not under common control, the reporting entity may determine that its fee arrangement is not a variable interest. |
| Related-party tiebreaker test                                           | The related-party tiebreaker test should be performed if (1) two or more related parties (including de facto agents) hold variable interests in the same VIE and (2) the aggregate of those interests, if held by a single party, would identify that party as the primary beneficiary. | The related-party tiebreaker test is performed if (1) two or more entities under common control hold variable interests in the same VIE and (2) the aggregate of those interests, if held by a single party, would identify that party as the primary beneficiary. The test is also required if power is shared by two related parties, even if the related parties are not under common control. | Because a decision maker considers its related parties interest only if it has an interest in the related party, the reporting entity may determine that it must deconsolidate a VIE. |

1 Paragraph BC69 of the ASU’s Basis for Conclusions indicates that entities that are considered to be under common control include “subsidiaries controlled (directly or indirectly) by a common parent, or a subsidiary and its parent.”
Appendix B — Comparison of Consolidation Requirements Under FIN 46(R) and ASU 2015-02

This appendix compares (1) the consolidation requirements under ASC 810-10 before ASU 2009-17 (i.e., FIN 46(R)) and (2) the new requirements under ASU 2015-02. It also outlines the potential impact of the changes. Note that this appendix applies only to entities that currently qualify for the investment company deferral.

<table>
<thead>
<tr>
<th>Subject</th>
<th>ASC 810-10 Before ASU 2009-17</th>
<th>ASU 2015-02</th>
<th>Potential Impact of Changes</th>
</tr>
</thead>
</table>
| Elimination of the ASU 2010-10 deferral       | When a VIE qualifies for the deferral (which applies primarily to investment companies), consolidation is required if the reporting entity will (or in certain instances the reporting entity is part of a related-party group that does) absorb a majority of the VIE’s expected economic exposure. | A VIE must be consolidated if the reporting entity has both of the following:  
• The power to direct the activities of a VIE that most significantly affect the VIE’s economic performance.  
• Economic exposure that could potentially be significant to the VIE.                                                                                           | All legal entities that qualified for the deferral will need to be evaluated under an approach similar to that in ASU 2009-17. The evaluation could result in a different consolidation conclusion.                                           |
<p>| Decision-maker or service-provider fee arrangements | A decision maker or service provider must be subject to kick-out rights to conclude that it does not hold a variable interest in a legal entity.                                                                                                                                   | Fees paid to a decision maker or a service provider that are “at market” and are commensurate with the services provided are generally (1) not in and of themselves considered variable interests and (2) excluded from the assessment of the decision maker’s or service provider’s economic exposure to a VIE. | Fewer fee arrangements will be considered variable interests. In addition, because most fees will be excluded from the evaluation of a decision maker’s economic exposure to a VIE, certain structures will not be consolidated. |
| Determining whether an entity is a VIE       | A legal entity is a VIE if it meets any of the conditions in ASC 810-10-15-14. Simple majority kick-out or participating rights are allowed to be considered in the determination of whether the equity-at-risk group controls the legal entity.                      | Legal entities other than limited partnerships — Determining whether the equity group has power is a two-step process. The reporting entity first needs to determine whether the equity holders have power over the most significant activities of a legal entity through their equity interests. If the equity holders as a group do not have power, kick-out and participating rights cannot be considered in the evaluation unless they are held by a single party (including related parties and de facto agents). | Legal entities other than limited partnerships — A legal entity may become a VIE if the equity holders as a group are no longer considered to have the power over the legal entity through their equity interests, no single equity holder possesses the unilateral ability to remove a decision maker, and the decision maker has a variable interest in the legal entity. |
|                                             |                                                                                                                                  |                                                                                                      | Limited partnerships (and similar entities) — A limited partnership is a VIE unless a simple majority or lower threshold (including a single limited partner) of all unrelated limited partners have kick-out or participating rights.                                                                                     |
|                                             |                                                                                                                                  |                                                                                                      | Limited partnerships (and similar entities) — Limited partnerships that do not give a single limited partner, or a simple majority of the limited partners, simple majority kick-out or participating rights would need to be evaluated for consolidation under the VIE guidance.                 |</p>
<table>
<thead>
<tr>
<th>Subject</th>
<th>ASC 810-10 Before ASU 2009-17</th>
<th>ASU 2015-02</th>
<th>Potential Impact of Changes</th>
</tr>
</thead>
</table>
| Determining whether a general partner should consolidate a partnership (or similar entity) that is not a VIE | A general partner is presumed to control a limited partnership that is not a VIE unless a simple majority of the limited partners (excluding the general partner’s related parties) have either of the following:  
  • The substantive ability to dissolve the limited partnership or otherwise remove the general partner without cause.  
  • Substantive participating rights (ASC 810-20).  
  The general partner’s economic exposure is not considered in the evaluation. | A general partner would not consolidate a limited partnership that is not a VIE. Rather, an individual limited partner would be required to consolidate the partnership if the limited partner has the substantive ability to dissolve the partnership or otherwise remove the general partner without cause (as distinguished from with cause). If the limited partner does not have such ability or the other limited partners have substantive participating rights, the limited partner is not required to consolidate the partnership. | More partnerships may be VIEs as a result of the requirement to consider if substantive rights exist in the evaluation of whether a partnership is a VIE. However, because the general partner must consider its economic interest in the VIE under the VIE consolidation guidance, partnerships that were consolidated under ASC 810-20 may be deconsolidated. By contrast, a limited partner may be required to consolidate a partnership that is not a VIE (i.e., if it has a simple majority of the substantive removal rights). |
| Determining whether a reporting entity should consolidate a VIE | A reporting entity is generally a VIE’s primary beneficiary (which consolidates a VIE) if it absorbs the majority of the VIE’s variability, as determined through quantitative analysis. | A reporting entity is required to consolidate a VIE if it has both (1) the power to direct the activities of a VIE that most significantly affect the entity’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. | A reporting entity that has power would use a lower threshold to evaluate its economic exposure to the VIE, which could result in the consolidation of a previously unconsolidated VIE (e.g., if a decision maker has a significant pro rata equity investment (e.g., 20 percent) in a VIE). |
| Definition of related parties (including de facto agents) | A party that has entered into an agreement that precludes it from selling, transferring, or encumbering its interests in a VIE without the prior approval of the reporting entity is a de facto agent of the reporting entity if that right of prior approval could constrain the party’s ability to manage the economics of its interest in a VIE. | There is no de facto agency relationship if both the reporting entity and the other party have the right of prior approval and the rights are based on mutually agreed terms entered into by willing, independent parties. | The reporting entity may have fewer de facto agents that must be considered in the consolidation analysis. |
| Related-party tiebreaker test | The related-party tiebreaker test should be performed if (1) two or more related parties (including de facto agents) hold variable interests in the same VIE and (2) the aggregate of those interests, if held by a single party, would identify that party as the primary beneficiary. | The related-party tiebreaker test is performed if (1) two or more entities under common control hold variable interests in the same VIE and (2) the aggregate of those interests, if held by a single party, would identify that party as the primary beneficiary. The related-party tiebreaker test is also required if power is shared by two related parties, even if the related parties are not under common control. | A decision maker is less likely to be required to consolidate a VIE solely as a result of an interest held by its related parties (e.g., equity method investee or employees) or by other investors that are subject to transfer restrictions (de facto agents). |

1 Paragraph BC69 of the ASU’s Basis for Conclusions indicates that entities considered under common control include “subsidiaries controlled (directly or indirectly) by a common parent, or a subsidiary and its parent.”
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 expected losses and expected residual returns of a legal entity. 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 has 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 and losses of the VIE (see further discussion in Section 7.3).

In addition, since the determination of the primary beneficiary of a VIE is no longer dependent on a reporting entity’s exposure to the expected variability in the economic performance of a legal entity, it is generally unnecessary for the reporting entity to perform a quantitative calculation of expected losses and expected residual returns to conduct a consolidation analysis under the VIE subsections of ASC 810-10. Rather, a qualitative assessment of the relevant facts and circumstances is generally sufficient for all aspects of the VIE consolidation analysis. Nevertheless, to perform a VIE consolidation analysis, the reporting entity should understand the relevant concepts underlying the quantitative approach described in the definitions of the terms “expected losses,” “expected residual returns,” and “expected variability.” This appendix describes those concepts and provides additional guidance.

C.1 The Need to Calculate Expected Losses and Expected Residual Returns

The concepts underlying expected losses and expected residual returns are important with respect to the following topics in the VIE subsections of ASC 810-10:

- 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 (see Section 4.4).
- The identification of silos and variable interests in specified assets (see Sections 6 and 4.3.11, respectively).
- The determination of whether a legal entity is a VIE (see Section 5).
- The reconsideration of whether a legal entity is a VIE (see Section 9).
- The determination of which party, within a commonly controlled related-party group or a group of related parties that share power, is the primary beneficiary of a VIE (see Section 7.4.2.4).

The VIE subsections of ASC 810-10, as amended by ASU 2015-02, generally do 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. However, in the following limited circumstances, it may be necessary for a reporting entity to calculate the expected losses and expected residual returns of a legal entity:
Appendix C — Expected Losses and Expected Residual Returns

- To determine whether a legal entity is a VIE, 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).

- To determine whether a fee paid to a decision maker or service provider is a variable interest, a reporting entity may need to perform a quantitative calculation of expected losses and expected residual returns of a legal entity in its evaluation under ASC 810-10-55-37(c) (see Section 4.4).

- To determine which party, within a commonly controlled related-party group or a group of related parties that share power, is the primary beneficiary of a legal entity, a reporting entity may need to calculate the expected losses of a legal entity to evaluate each party’s exposure to the expected losses 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

<table>
<thead>
<tr>
<th>ASC 810-10-20</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Expected Losses</strong></td>
</tr>
<tr>
<td>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.</td>
</tr>
</tbody>
</table>

| **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.

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.

Although the VIE model also requires a cash flow scenario technique, it mandates that certain cash flows (those stemming from nonvariable interests) be included in, and certain cash flows (those stemming from variable interests) be excluded from, the cash flows that otherwise would be used to calculate the expected value of the VIE under Concepts Statement 7. For example, cash flow amounts representing distributions to holders of variable interests are not included as cash outflows of the VIE in the determination of the VIE’s expected losses or expected residual returns. Similarly, cash flow amounts that represent receipts from holders of variable interests are not

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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.
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 attributable to nonvariable interests. The objective of the expected cash flows calculation under the VIE model is to arrive at the single estimate 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.

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 in 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 below 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 nonvariable interests in the entity. That is, the objective of the net asset calculation is to include only the estimated cash flows stemming from nonvariable 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, net assets exclusive of variable interests include interests in specific assets, as described in ASC 810-10-25-55 and 25-56, because those interests are not variable interests in the legal entity. 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 of the legal entity (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).

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 nonvariable interests from the variable interests in the legal entity.
- **Step 2** — Develop the scenarios of estimated cash flows attributable to nonvariable interests 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 Nonvariable Interests From the Variable Interests in the Legal Entity**

Each of the legal entity’s assets, liabilities, contracts, and equity items represents an “interest,” some of which are considered “variable interests” and some of which are not. 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 and nonvariable interests from among the legal entity’s assets, liabilities, equity, and other contractual arrangements. 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 nonvariable interests 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 Section 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 nonvariable interests, 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 nonvariable interests 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 Nonvariable Interests 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 nonvariable interests 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 flows that would be paid to or received from a holder of 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 expected (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 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/expected 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 the following:

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.3.10.)

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 price 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 nonvariable interests (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.3.10.)

- 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 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 Concept 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 flows representing distributions to holders of 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 nonvariable interest. 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 in ASC 810-10. 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 in ASC 810-10, 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 ASC 810-10. 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 in ASC 810-10, 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. The cash flow method does not anticipate changes in future interest rates. In an expected loss/residual return calculation, the only variations in the risk-free rates used are within each cash flow scenario — to 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 in ASC 810-10, 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.
Appendix C — Expected Losses and Expected Residual Returns

<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 based on 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 expected to be prevalent under the VIE model in ASC 810-10 (as amended by ASU 2015-02), the top-down method may continue to 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. Because neither of the conditions necessary for application of the bottoms-up method will be expected to 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).

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  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 will generally not be required to calculate expected losses and expected residual returns in performing a consolidation analysis under the VIE subsections of ASC 810-10. 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 reporting 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 payments 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.

C.5.1  Performing Step 1

Under step 1 of the calculation, a reporting entity must distinguish the nonvariable interests from the variable interests in the legal entity (see Section C.3). The interests in PowerCo are analyzed below.

<table>
<thead>
<tr>
<th>Interest</th>
<th>Analysis</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>
</tbody>
</table>
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.

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.

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 “underlying is an observable market rate, price, index of prices or rates, or other market observable variable” and (2) the “counterparty is senior in priority relative to other interest holders in the legal entity.” 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.)

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.

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 subsections of ASC 810-10, 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 nonvariable interests under the VIE model (see Section C.3).

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 flow to or from the holders of 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 will 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 From or Paid to the Entity by Nonvariable Interests</strong></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).

To determine the expected cash flows of the entity under the VIE model in ASC 810-10, 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>
<thead>
<tr>
<th>Table C-2 — Undiscounted Expected Cash Flows</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>PowerCo</strong></td>
</tr>
<tr>
<td><strong>Undiscounted Estimated Cash Flows</strong></td>
</tr>
<tr>
<td>(A)</td>
</tr>
<tr>
<td><strong>Probability</strong></td>
</tr>
<tr>
<td>(B)</td>
</tr>
<tr>
<td><strong>Probability-Weighted Undiscounted Expected</strong></td>
</tr>
<tr>
<td>Cash Flows (A x B)</td>
</tr>
<tr>
<td>Scenario 1</td>
</tr>
<tr>
<td>Scenario 2</td>
</tr>
<tr>
<td>Scenario 3</td>
</tr>
<tr>
<td>Undiscounted expected cash flows under the VIE model in ASC 810-10</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).

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>
</tbody>
</table>

Discounted expected cash flows under the VIE model in ASC 810-10 100% $10,418,632

* Table C-4 below illustrates the calculation of discounted estimated cash flows for Scenario 3.

Table C-4 — Undiscounted Cash Flows (Scenario 3)

<table>
<thead>
<tr>
<th>Discounted Cash Flows Attributable to Nonvariable Interests</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 received from or paid to the entity by nonvariable interests</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>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 above, 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 Variables 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>$579,222</td>
<td></td>
</tr>
<tr>
<td>Scenario 2</td>
<td>5,451,098</td>
<td>50</td>
<td>241,782</td>
<td>241,782</td>
<td></td>
</tr>
<tr>
<td>Scenario 3</td>
<td>1,783,654</td>
<td>25</td>
<td>(821,004)</td>
<td>$ (821,004)</td>
<td>$821,004</td>
</tr>
<tr>
<td>Total</td>
<td>$10,418,632</td>
<td>100%</td>
<td></td>
<td></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

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.\(^1\) That guidance is presented in the following subsections of ASC 810-10: (1) the “general” subsections, (2) the VIE subsections, and (3) the subsections on the consolidation of entities controlled by contract.

As discussed in Section 3, in determining whether a legal entity should be consolidated, a reporting entity first determines whether the legal entity is a VIE. Only after the reporting entity has determined that the legal entity

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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.
is not subject to the VIE model does it apply the guidance in the general subsections or in the subsections on the consolidation of entities controlled by contract.

The guidance in the general subsections of ASC 810-10 applies to voting interest entities (referred to hereafter as the “voting interest entity model”). The guidance in the subsections 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 model and the VIE model. See Table 1-1 in Section 1.4 for differences between the voting interest entity model and the VIE model.

D.1 General Consolidation Principles

The following flowchart shows the detailed steps that a reporting entity should follow when evaluating a legal entity under the voting interest entity model.
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.
  - 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.
  - 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.
  - 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).

- 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.

- Subparagraph superseded by Accounting Standards Update No. 2013-08.
- Subparagraph superseded by Accounting Standards Update No. 2015-02.
- Subtopic 810-30 shall be applied to determine the consolidation status of a research and development arrangement.
- 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.
- 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.
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. Before the issuance of ASU 2015-02, the voting interest entity model was codified in (1) the guidance on consolidation of corporations in ASC 810-10 and (2) the guidance on consolidation of limited partnerships (and similar entities) in ASC 810-20. ASU 2015-02 eliminated the specific consolidation guidance on limited partnerships, and now the voting interest entity model is codified entirely in ASC 810-10. Accordingly, limited partnerships that are not VIEs are now evaluated for consolidation in essentially the same manner as corporations that are not VIEs.

D.1.1 Limited Partnerships (and Similar Entities)
For limited partnerships, 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 remove the general partner or dissolve the partnership without cause. Before the amendments to ASC 810 made by ASU 2015-02, the general partner of a limited partnership was presumed to control the limited partnership under the voting interest entity model and was required to consolidate the limited partnership unless the limited partners had either (1) the substantive ability to dissolve (liquidate) the limited partnership or otherwise remove the general partner without cause or (2) substantive participating rights. However, under ASC 810-10 as amended by ASU 2015-02, 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.

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” (see also 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 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:

- Control of the board of directors/governing body of a legal entity other than a limited partnership. As stated in ASC 810-10-15-8A, “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, 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. For limited partnerships, this condition would be met when a limited partner, directly or indirectly, controls more than 50 percent of the kick-out rights of the limited partnership without owning more than 50 percent of the limited partnership interests.

In the absence of participating rights held by other parties, the following conditions 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 (note that the reporting entity must use significant judgment in determining whether an investor with less than a majority of the outstanding voting interests controls an investee):

- Possession of options or other securities convertible into voting interests, if such securities are currently exercisable, at little or no economic cost.
- Holding of a majority of total equity or “at risk” capital, resulting in potential influence beyond the investor’s percentage ownership of voting interests.
- Ability to sell, lease, or otherwise dispose of the investee’s assets or to unilaterally enter into contracts or commitments on behalf of the investee.
- 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.
- The investee is a mechanism to finance a project, and the investor will eventually acquire the project.
- The other investee owners have little or no influence or have little or no risk, including situations in which they have the right to put their voting interests to either the investee or the investor.
- The investor is liable for or has guaranteed the investee’s debt.
- The investor has the right or is obligated to offer to buy out the other voting interests in the investee.

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 joint control in which a joint venture arrangement may exist, see ASC 323-10-15-3.
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, reducing its voting interest in Y to 50 percent. However, X continued to control the election of directors to the Y’s board, and the other equity holders did not have substantive participating rights.

In this example, Company 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.2 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).

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 allow for control currently) 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.6 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.

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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.

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.
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).

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-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 remove the general partner or dissolve the partnership without cause 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 in B, A does not unilaterally control the kick-out rights of B because it exerts only significant influence over the 16 percent of limited partnership interests owned indirectly through C.

D.1.6.2 Evaluation of Liquidation and Withdrawal Rights as Kick-Out Rights

ASU 2015-02 updated the definition of a kick-out right to establish a separate definition applicable to voting interest entities. The definition states that the right “to dissolve (liquidate) the limited partnership . . . without cause” is a kick-out right.

Paragraph BC49 of the Basis for Conclusions 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 substantive7 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.

A withdrawal right represents a liquidation right only if its exercise would result in the liquidation (or dissolution) of the entire limited partnership. 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 explicitly 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 substantive8 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 above).

**D.1.6.2.1 Evaluation of Buy-Sell Clauses as a Liquidation Right**

A buy-sell agreement could take various forms, but generally permits one investor to initiate the purchase or sale of another investor’s interest. These provisions would not typically be considered a liquidation right. See Example 5-28.

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7 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.”

8 See footnote 7.
D.2 The Effect of Noncontrolling Rights on Consolidation

**ASC 810-10**

25-2 Paragraph 810-10-15-10(a)(i)(v) 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)(i)(v) 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.

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 who 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.

25-7 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.

25-8 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

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ASC 810-10-20

**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

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D.2.3 Factors to Consider in Evaluating Whether Noncontrolling Rights Are Substantive Participating Rights

### ASC 810-10 (continued)

**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 810-10-20

**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.” The retention of substantive participating rights by noncontrolling shareholders or noncontrolling limited partners would override 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.

### 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.

f. 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 810-10-15-4 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

Example D-6

Assume that Entities A and B contributed certain assets to Entity C and that they 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 only be replaced by the party that elected them. The following actions require the unanimous consent of all five managers:

- To borrow money on behalf of C in an amount in excess of $500,000.
- To renew, extend, modify, rearrange, or refinance borrowings by C in excess of $500,000.
- To acquire, lease, hold, or sell any or all real or personal property of C (or any interest therein) involving amounts or values in excess of $500,000.
- To pay or incur any expense, debt, or obligation of C in excess of $500,000.
- To approve the annual operating and capital budgets of C.
- To approve any long-term (more than one year) supply 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 example, A should not consolidate C. The rights outlined above are expected to allow B to effectively participate in significant decisions that would be made in C's ordinary course of business and 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.

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 diminish that party’s right to participate. 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; however, the noncontrolling shareholder has a small economic interest, and the majority owner has a call option on the noncontrolling shares that is prudent, feasible, and substantially within the control of the majority owner to exercise. In this case, the right to participate in the operating and capital decisions may not overcome control by the majority owner. In determining whether noncontrolling rights are substantive participating rights, a reporting entity must use significant judgment and consider all relevant facts and circumstances.

In addition, while ASC 810-10-25-14A defines substantive kick-out rights that are specific to limited partnerships, a reporting entity may analogize to it when evaluating either (1) kick-out rights related to legal entities other than limited partnerships or (2) approval or veto rights granted to a noncontrolling interest holder.

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 modified by the phrase “other than in the ordinary course of business.” In situations in which that phrase was used to modify a noncontrolling interest holder’s approval or veto rights and was vaguely defined, the SEC objected to consolidation by the majority owner. The contractual documentation 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 is otherwise 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.

This guidance also applies to non-SEC registrants.

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

Entities A and B restructured a 50-50 corporate joint venture agreement involving Entity C. Under the agreement, A has 90 percent of the voting interest in C and 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 extricate itself from C’s operations but also allows B to retain its financial interest in certain royalties and fixed payments through its remaining 10 percent 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 or C’s ability to conduct its primary business.

In this example, the rights granted to B do not allow B to participate in the management of C but rather protect its financial interest in the event that A decides to substantially change the nature of C’s primary business. Therefore, the rights granted to B are not related to dispositions of assets that are expected to be undertaken in the ordinary course of business. As a result, these rights 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
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 . . . .

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 under the cost method (if the investee’s stock does not have a readily determinable fair value).
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. As a result of discussions with the SEC staff, we are aware that the SEC staff did not object to a registrant’s conclusion to deconsolidate its Venezuelan operations as of December 2014. We understand that the two primary arguments cited by the registrant were (1) an other-than-temporary lack of currency exchangeability and (2) the existence of several government limitations on the registrant’s ability to control its Venezuelan operations. 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.

A reporting entity must use significant judgment in determining whether, under the specific facts and circumstances, the nonconsolidation of a majority-owned foreign subsidiary is appropriate. In making this determination with respect to operations in a foreign jurisdiction, the reporting entity should consider factors that include, but may not be 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. For example, with respect to Venezuelan subsidiaries, recent developments related to the downward trend in the price of oil might affect expectations about the future direction of restrictions on currency exchange in Venezuela (i.e., the trend could adversely affect the Venezuelan government’s supply of U.S. dollars and thus further limit the amount of currency available through the established currency exchange mechanisms).
- 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.

The mere fact that currency exchangeability is lacking or that government controls exist may 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 a presumption that a reporting entity should consolidate its foreign subsidiary. However, the existence of the above factors represents negative evidence that a reporting entity should consider in determining 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 the following:

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 use the fair value or cost method, depending on whether the investment has a readily determinable fair value under ASC 320-10.
- 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 nonconsolidated subsidiary by using the cost method.
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) "reclassify the cash contributed to the [Newco] as restricted cash," (2) "recognize research and development expense as the research and development activities are performed," and (3) "account 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.

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

ASC 810-10

15-20 The guidance in the Consolidation of Entities Controlled by Contract Subsections applies, in part, to contractual management arrangements with both of the following characteristics:

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)

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.

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.

15-21 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.

15-22 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
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.

**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.
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 financing entities (see Section E.2).
- Real estate structures (see Section E.3).
- Low-income housing tax credit structures (see Section E.4).
- Power and utilities entities (see Section E.5).

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 (e.g., financial information of a subsidiary included in the reporting entity’s disclosures under SEC Regulation S-X, Rule 3-10), 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 ones have 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.
Appendix E — Industry-Specific Guidance

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 entity's assets. If the specified asset or assets are less than half of the total fair value of the 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.

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 represent 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 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 Section 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 VIE’s significant activities 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 Section 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 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 legal entity’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 legal entity’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 of default 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.
**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.

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:
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:

- 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.
- 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.
- 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.

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, including the VIE’s actual residual returns, if any. 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:

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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.

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.
Appendix E — Industry-Specific Guidance

**ASC 810-10 [Case C, continued]**

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:

![Diagram of FASB’s Case C]

**ASC 810-10 [Case C, continued]**

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 specified 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.
Appendix E — Industry-Specific Guidance

ASC 810-10 [Case C, continued]

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).

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
Appendix E — Industry-Specific Guidance

**ASC 810-10 [Case D, continued]**

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.

**55-140** 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.

The following diagram illustrates the scenario described above in the FASB’s Case D:

![Diagram]

**ASC 810-10 [Case D, continued]**

55-141 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.

55-142 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.

55-143 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
ASC 810-10 [Case D, continued]

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.

55-144 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.

55-145 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.

55-146 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.

ASC 810-10 [Case E: Guaranteed Mortgage-Backed Securitization]

Case E: Guaranteed Mortgage-Backed Securitization

55-147 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.

55-148 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.

55-149 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.

55-150 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.

55-151 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:

![Diagram](image-url)

### ASC 810-10 [Case E, continued]

#### 55-152

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.

#### 55-153

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.

#### 55-154

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.

#### 55-155

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.

#### 55-156

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.

#### 55-157

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.

#### 55-158

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.
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.

Case F: Residential Mortgage-Backed Securitization

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:
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.

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.

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.

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.

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.

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).

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 Financing Entities

E.2.1  Consolidation Analysis

Collateralized financing entities (CFEs) are unique securitizations in that there is typically no transfer of assets from the sponsor to the securitization entity. Instead, the CFE 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 quality 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).

The CFE employs a collateral manager (typically a bank or an investment manager that sponsors the CFE) that performs various functions for the CFE during its different stages. For example, during the initial loan-accumulation phase, the collateral manager is responsible for acquiring the assets for the CFE 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 when there is 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 CFE’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 the securitization of the CFE may be considered a fundamental redesign of the CFE, there may be different activities that most significantly affect the potential VIE’s economic performance during each phase.

E.2.2  Determining Whether the CFE 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 CFE 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 CFE should be evaluated under the VIE model.

Although a CFE may issue equity interests that provide credit support to the legal entity’s senior investors, the tranch capital structure of the CFE, as well as the multiple series of debt instruments typically issued by a CFE, will usually serve as qualitative evidence that the legal entity has insufficient equity at risk.

In addition, although ASU 2015-02 clarified how to evaluate whether the equity investors have the power to direct the activities of a CFE (which is part of the second condition above — i.e., that the equity holders (as a group) lack any of the three characteristics of a controlling financial interest), this clarification would most likely not change the conclusion that a CFE is a VIE. This is because even if a CFE 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 CFE. Unless a single equity holder has the unilateral ability to remove the collateral manager, or the collateral manager is acting as an agent on behalf of the equity group (i.e., the decision-making rights are not considered a variable interest), the CFE would be a VIE. See Section 5 for further discussion of whether a legal entity is a VIE.
E.2.3 Determining the Primary Beneficiary of a CFE

The chart below illustrates the steps a collateral manager would take in determining whether it is required to consolidate a CFE. The sections that follow the chart discuss the steps in detail.

<table>
<thead>
<tr>
<th>Step 1: Does the collateral manager have a variable interest in the entity?</th>
</tr>
</thead>
<tbody>
<tr>
<td>No</td>
</tr>
<tr>
<td><strong>No</strong></td>
</tr>
<tr>
<td><strong>Collateral manager does not consolidate the CFE.</strong></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Step 2: Does the collateral manager have the power to direct the activities that most significantly affect the entity?</th>
</tr>
</thead>
<tbody>
<tr>
<td>Yes</td>
</tr>
<tr>
<td><strong>Yes</strong></td>
</tr>
<tr>
<td><strong>Collateral manager does not consolidate the CFE.</strong></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Step 3: Does the collateral manager have a potentially significant interest?</th>
</tr>
</thead>
<tbody>
<tr>
<td>No</td>
</tr>
<tr>
<td><strong>No</strong></td>
</tr>
<tr>
<td><strong>Collateral manager is the primary beneficiary</strong></td>
</tr>
</tbody>
</table>

| Yes                             |
| **Yes**                        |
| **Collateral manager consolidates the CFE.** |

* A collateral manager must also assess whether it would be required to perform the related-party tiebreaker test (see step 4 below).

E.2.3.1 Step 1: Does the Collateral Manager Have a Variable Interest in the CFE?

Before ASU 2015-02, a collateral manager’s decision-making arrangement was a variable interest unless the following six criteria under ASC 810-10-55-36 were met:

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

b. Substantially all of the fees are at or above the same level of seniority [in the waterfall on distribution dates as other expenses of the entity].

c. The decision maker or service provider does not hold other interests in the [entity] that individually, or in the aggregate, would absorb more than an insignificant amount of the [entity’s] expected losses or receive more than an insignificant amount of the [entity’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. The total amount of anticipated fees are insignificant relative to the total amount of the [entity’s] anticipated economic performance.

f. The anticipated fees are expected to absorb an insignificant amount of the variability associated with the [entity’s] anticipated economic performance.

A collateral manager’s fees are typically structured with a portion at the top of the waterfall (senior fee), a portion at the bottom of the waterfall (subordinated fee), and an additional “contingent” management fee if the CFE performs well (incentive fee). Under GAAP before ASU 2015-02, a collateral manager’s decision-making arrangement was often deemed to be a variable interest because it did not meet criterion (b) above, under which the fees received must not have been subordinated. Further, if an incentive fee was present, the arrangement may not have met conditions (e) or (f).

ASU 2015-02 eliminated the criteria related to the fees’ priority level (criterion (b)) and significance (criteria (e) and (f)). Therefore, 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 CFE’s variability (criterion (c)), and (3) whether the arrangement’s terms are customary (criterion (d)).
Another of ASU 2015-02’s significant changes is the requirement regarding how a collateral manager should consider interests held by its related parties or de facto agents when evaluating whether a decision-making arrangement is a variable interest. When a collateral manager evaluates its economic exposure to a VIE (criterion (c)), it should consider its direct interests in the CFE 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 and that related party owns 40 percent of the residual tranche of the CFE being evaluated, the collateral manager’s interest would be considered equivalent to an 8 percent direct interest in the residual tranche of the CFE.

By contrast, if a collateral manager has an indirect interest in a CFE 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 rather than just its proportionate share. In situations in which the collateral manager does not hold an interest through 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).

ASU 2015-02 did not amend the current threshold used in the evaluation of whether the collateral manager’s other interests absorb more than an insignificant amount of the CFE’s variability. As a general guideline, this criteria would be met if the variability absorbed by the collateral manager through its other variable interests in the CFE exceeds, either individually or in the aggregate, 10 percent of the CFE’s expected variability. However, because of the subjective nature of the calculation of expected losses and expected residual returns, this is not a bright-line requirement or safe harbor.

The evaluation of a collateral manager’s economic exposure through its other interests should take into account the CFE’s purpose and design. In addition, all risks and associated variability that are absorbed by any of the CFE’s variable interest holders should be considered. The type of interest held by a collateral manager will affect its economic exposure to the CFE and, accordingly, the collateral manager’s conclusion about whether its decision-making arrangement is a variable interest. For example, a first-loss piece is more likely to expose the collateral manager to a significant amount of expected losses or the potential to generate significant expected residual returns than a senior interest.

These changes will have significant implications for collateral managers of CFEs. 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 CFE (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 CFE’s variability, the collateral manager will not have a variable interest in the CFE and will not consolidate the CFE.

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 CFE?**

When the collateral manager has other interests in the CFE (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 CFE’s variability, the collateral manager would have a variable interest in the CFE and must determine whether it has power over the CFE’s most significant activities.
Appendix E — Industry-Specific Guidance

The economic performance of a CFE 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 CFE (like voluntary prepayments) and, therefore, do not enter into the power analysis. The activities that most significantly affect the underlying assets’ performance in a CFE 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 CFE? 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 CFE’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:

<table>
<thead>
<tr>
<th>Situation</th>
<th>Corresponding Discussion</th>
</tr>
</thead>
<tbody>
<tr>
<td>The collateral manager can be replaced without cause by a single unrelated party.</td>
<td>See discussion below of kick-out rights.</td>
</tr>
<tr>
<td>All important decisions require the consent of one or more unrelated parties.</td>
<td>See discussion below of shared power and participating rights.</td>
</tr>
<tr>
<td>The collateral manager manages less than a majority of the assets in the VIE.</td>
<td>See discussion below of multiple parties with power.</td>
</tr>
</tbody>
</table>

See Section 7.2 for further discussion of evaluating the power criterion.

E.2.3.2.2 Kick-Out Rights

Although not common for CFEs, substantive kick-out rights (i.e., those that can be exercised at will and not upon a contingent event) held by a single unrelated party 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 substantive participating right when the consent is required for all the activities that most significantly affect the legal entity’s economic performance. 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).
While ASU 2015-02 diminishes the effects of a related party’s (or de facto agent’s) interest in evaluating a collateral manager’s economic exposure to a CFE, it retains the guidance prohibiting parties in a related-party group (including de facto agents) from concluding that they share power. Accordingly, if power is considered shared (e.g., the collateral manager is required to obtain approval from the residual holder for any 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 CFE. ASU 2015-02 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.

Example E.2-1

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 the $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 CFEs, 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 CFE.

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 CFE that represent a more than insignificant economic interest in the CFE, 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 CFE 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 CFE 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 CFE. Each member of a related-party group with a variable interest in the CFE 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 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 CFE that absorbs more than an insignificant amount of the CFE’s variability (see Section 4.4.2). In addition, when performing the economics-criterion assessment, the collateral manager is required to consider interests held through related parties under common control as if they were held directly by the decision maker (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 CFE 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 CFE 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.

### 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 CFE, but the related-party group (including de facto agents) possesses the characteristics of a controlling financial interest, and substantially all of the CFE’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 CFE.

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 CFE’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 CFE.
- 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 CFE, it would need to deconsolidate the CFE as of the date the circumstances changed and recognize a gain or loss. See Section 7.1.5 for a discussion of VIE reconsideration events.
E.2.5 Accounting for Interests in Unconsolidated CFEs

If a collateral manager is not required to consolidate a CFE, it must determine the appropriate accounting for any interests it holds in the CFE. Most interests in CFEs 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 CFE); 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. In addition, 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 CFE as either AFS or trading.

If a collateral manager is required to deconsolidate a CFE as a result of the initial adoption of ASU 2015-02, the carrying value of any retained interests in the deconsolidated subsidiary are initially measured on the basis of the amount that would have been reflected in the collateral manager’s financial statements if ASU 2015-02 had been effective when the collateral manager first became involved with the CFE, unless determining such amount is not practicable. Accordingly, if the assets in the CFE were originated by the collateral manager and transferred by the collateral manager to the previously consolidated CFE (rather than acquired in the market), the collateral manager would be required to consider the requirements in ASC 860 on the derecognition of financial assets to determine the carrying value of any retained interests in the CFE.

E.2.6 Accounting for Consolidated CFEs

Collateral managers are required to measure a CFE’s assets and liabilities at fair value when they initially consolidate a CFE. 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. In August 2014, the FASB issued ASU 2014-13, which allows a reporting entity that measures both the financial assets and financial liabilities of a consolidated CFE at fair value to use a measurement alternative to determine the fair value. ASU 2014-13 is effective for public business entities for annual periods, and interim periods within those annual periods, beginning after December 15, 2015. For entities other than public business entities, the amendments are effective for annual periods ending after December 15, 2016, and interim periods beginning after December 15, 2016. Early adoption of ASU 2014-13 is permitted. See Section 12.2.6 for further discussion.

E.2.7 Risk Retention Rules

On October 22, 2014, the SEC and five other federal agencies¹ 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.²

The rule was initially proposed in April 2011 and reproposed in September 2013. Both proposals received significant feedback, much of it negative. In response, the final rule eliminated the proposed cash flow restriction

¹ 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.
² 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 Exchange Act.
on eligible horizontal residual interests and the need to perform a fair value calculation to determine an eligible vertical interest (but retains the requirement for a horizontal interest). However, the rule did not address a number of concerns, such as the request by many constituents that the requirements provide a broad exemption for “open-market CLOs” in which the underlying assets are acquired in the market rather than originated by the sponsor.

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 security retained.

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. The majority-owned affiliate aspect of the requirement is receiving much attention. Of particular 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 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 consider whether establishing these types of structures would 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 rather than a vertical interest (or a combination), there is a greater risk that the structure would be consolidated by the sponsor.

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
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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]

Example E.2-2

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 new 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 power to direct 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).

<table>
<thead>
<tr>
<th>Investment Manager (Equity Interest)</th>
<th>Other Unrelated Entities</th>
</tr>
</thead>
<tbody>
<tr>
<td>5%</td>
<td>95%</td>
</tr>
</tbody>
</table>

CLO

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.

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 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 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.

A REIT’s conclusion that it is required to consolidate an operating partnership may not differ from its conclusion under GAAP before it adopted ASU 2015-02. If the operating partnership is now considered a VIE under ASU 2015-02, the REIT would have to comply with the VIE presentation requirements. In addition, the REIT would be required to 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.4 LIHTC Structures

E.4.1 Background

In a low-income housing tax credit (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.

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<table>
<thead>
<tr>
<th></th>
<th>General Partner</th>
<th>Limited Partner</th>
</tr>
</thead>
<tbody>
<tr>
<td>Rent</td>
<td></td>
<td>99.9% Interest</td>
</tr>
<tr>
<td>Expenses</td>
<td>0.1% Interest and Fee Arrangement</td>
<td></td>
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</tbody>
</table>

LIHTC Partnership
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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 a 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 residual returns 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 neither 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 the limited partners may conclude that they do not meet the power criterion. However, facts and circumstances (including whether the partners have other interests in the partnership or each other) need to be considered.

Further, 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 of the general partner. For example, if the general partner is restricted from disposing of its interest without the approval of the limited partners, the general partner would be considered a de facto agent of the limited partner. In such instances, a reporting entity would perform the related-party tiebreaker test to determine whether:

- 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, a reporting entity should 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 party in the related-party group is required to consolidate the VIE, and (3) substantially all of the activities of the VIE either involve or are conducted on behalf of the reporting entity. However, 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 and the following conditions 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.
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.

Although an investor’s consolidation conclusion regarding a LIHTC structure may not change as a result of the adoption of ASU 2015-02, a determination that a LIHTC partnership is a VIE as a result of the ASU would affect whether the investor has to comply with the VIE presentation and disclosure requirements.

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 sections of this publication by 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 Section 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 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

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3 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.
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 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.5-1 below illustrates how to assess whether 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.5-1

- 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.5-1 below outlines how to assess whether a PPA, tolling agreement, or similar arrangement between the Utility and PowerCo in Example E.5-1 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).
## Appendix E — Industry-Specific Guidance

### Table E.5-1 — 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>
<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>
<tr>
<td>Variable-price forward contract to purchase electricity — reimburses legal entity for costs of fuel and O&amp;M</td>
<td>Market-price forward contract to purchase fuel from a third-party provider</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 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&amp;M costs will be borne by the purchaser.</td>
</tr>
<tr>
<td>Variable-price forward contract to purchase electricity — reimburses legal entity for costs of fuel and O&amp;M</td>
<td>Market-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 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&amp;M costs will be borne by the purchaser.</td>
</tr>
</tbody>
</table>

*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.

**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.
## 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 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 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.

### 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 discussed in ASC 810-10-55-39 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:

### Table E.5-1 — Assessing Whether PPAs, Tolling Agreements, or Similar Arrangements Are Variable Interests (continued)

<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>Variable-price forward contract to purchase electricity — reimburses the legal entity for costs of fuel and O&amp;M. A component of the variable-price forward contract is considered an operating lease under ASC 840</td>
<td>Market-price forward contract to purchase fuel from a third-party provider</td>
<td>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&amp;M costs will be borne by the purchaser.</td>
</tr>
</tbody>
</table>

* 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.
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.

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
pursuant to the Public Utility Regulatory Policies Act (PURPA) 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).
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.5-2**

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.5.3 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.

**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 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 outlined in ASC 810-10, which 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 fail to meet the condition in ASC 810-10-15-17(d).

**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 condition) and (2) a potentially significant interest in the VIE (economics condition). 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 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 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 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.

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**Example E.5-3**

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, credit 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. While it is appropriate to exclude from the analysis risks that cannot be affected by the direction of these activities, there may be situations in which the activities related to the risks are asserted to be “outside” the entity. 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 would 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.).

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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.5.4.2 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.

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 significance of those decisions may vary on the basis of the type of legal entity being evaluated. For example, the importance of certain decisions related to a coal-fired power plant may be different from the importance of decisions related to a renewable energy facility (e.g., wind farms or solar farms). If, for instance, commodity price risk is the risk that most significantly affects the legal entity’s economic performance, the reporting entity that 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 impact of dispatch. On the other hand, if no party makes dispatch decisions, as may be the case with certain renewable energy technologies, the analysis of the power to direct should focus on the other ongoing activities (e.g., O&M) if those activities are expected to have a significant impact on the economic performance of the legal entity.

Some have argued that because of the importance of O&M, unless the O&M performance is easily achieved, O&M would generally be the most significant activity of the VIE. However, we would expect that 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) would typically not outweigh the activities associated with the potential volatility from commodity price risk. Accordingly, 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 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 versus a net exposure to the spark spread) should also be considered. For example, in a traditional natural gas tolling arrangement, the off-taker’s exposure is to the spark spread since every dispatch decision effectively involves a purchase of natural gas and a contemporaneous sale of electricity. Availability guarantees, minimum production guarantees, and guaranteed heat rates are examples of features that may require consideration in the assessment of the potential variability associated with 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 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). Finally, there may be unique considerations related to in-substance real estate (including many power plants) that may hinder the ability to derecognize the generating facility once it has been recognized on the balance sheet through consolidation. See Section E.5.5.1 for more details on the accounting and reporting for decreases in ownership of a subsidiary.

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

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5 The 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.
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).

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 other 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.5-4**

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.

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.5-5**

Utility A (off-taker) enters into a short-term PPA with Power Inc. (a VIE) that is a variable interest. In addition, A has the power to direct the significant activities of the VIE (through its dispatch rights) during the term of the PPA. Since A has the power to direct the significant activities of the VIE during the PPA, A must consider whether the short-term PPA results in A’s consolidation of Power Inc. during the PPA term (followed by deconsolidation at the expiration of the PPA).
Example E.5-5 (continued)

In the absence of any unusual terms such as puts or calls on the plant, it is generally not expected that a short-term PPA will require consolidation by an off-taker unless the off-taker has power over the majority of the significant activities (as may be the case with a short-term PPA that is entered into near the end of the useful life of a plant). Specifically, the evaluation of the ability to direct the most significant activities involves a consideration of power over the remaining life of the legal entity. In this case, the other off-takers will have power over the same significant activities (the ability to control dispatch) after the PPA term. Accordingly, while the ability to direct dispatch for less than half of the VIE’s remaining life would give A power over the significant activities during the term of the PPA, other unrelated parties will be responsible for the same significant activity after the PPA term. Unless A’s PPA is for the majority of the remaining plant life, A will not have power over the majority of the significant activity or activities. Therefore, as long as there are no other terms in the PPA suggesting that A has power over activities beyond the PPA term, A would not be required to consolidate the VIE. However, if the PPA contains fixed-price puts or calls on the plant at the end of the PPA term or provisions that transfer ownership of the plant to A at the expiration of the PPA, consolidation may be appropriate despite the short-term nature of the arrangement.

Any other rights that the various parties hold (e.g., A has O&M responsibility during the entire life of the plant) should also be considered. In addition, if the PPA was for more than half of the VIE’s remaining life, but another party has the ability to determine whether to enter into a new PPA or sell the plant after the PPA ends, those other rights should be considered in the evaluation.

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)

In addition to assessing the requirements of ASC 810, reporting entities would need to apply the guidance on real estate sales 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 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.

- **Off-takers** — 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 is also likely to apply. 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.

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.

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6 ASC 360-20-40-38 indicates that the transaction would be accounted for as a financing, leasing, or profit-sharing arrangement.
Appendix F — Deconsolidation/Derecognition

F.1 Introduction

ASC 810-10

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. A sale of in substance real estate (for guidance on a sale of in substance real estate, see Subtopic 360-20 or 976-605)
      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).
   b. A group of assets that is a nonprofit activity or a business, except for either of the following:
      1. A sale of in substance real estate (for guidance on a sale of in substance real estate, see Subtopic 360-20 or 976-605)
      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).
   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 605 on revenue recognition
      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. Topic 360 or 976 on sales of in substance real estate.

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 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
Appendix F — Deconsolidation/Derecognition

ASC 810-10 (continued)

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 meets both of the characteristics in ASC 810-10-25-38A 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 805-10-55-4 for the definition of a business), there does not need to be a separate subsidiary established (i.e., a group of assets representing a business can be
Appendix F — Deconsolidation/Derecognition

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 605). 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.

In essence, ASC 810-10-40-5 states 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.

F.2.1 Deconsolidation or Derecognition of In-Substance Real Estate

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\(^1\) 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.

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\(^1\) ASC 976-605 provides guidance on sales of retail land. For the remainder of this section, 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 the 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. To the extent a reporting entity believes application of the ASC 810-10-40 deconsolidation guidance is appropriate, 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 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 practically, 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 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.2.2 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, the sale of future revenues within the scope of ASC 605.

In May 2014, the FASB issued ASU 2014-09, resulting in a new revenue recognition standard (ASC 606) that expands the transactions that are subject to revenue recognition guidance. However, ASU 2014-09 is not effective until annual reporting periods beginning after December 15, 2017, for public business entities and for annual reporting periods beginning after December 15, 2018, for nonpublic entities.

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.

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 recent consultations that have involved 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.2.4 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>$5</td>
<td>– * $9</td>
</tr>
<tr>
<td>Arrangement 2</td>
<td></td>
<td>10</td>
</tr>
<tr>
<td>Total loss recognized by A</td>
<td>$5</td>
<td>10</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, the FASB observed in paragraph B57 of the Basis for Conclusions of Statement 160 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, 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 Over 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-3). 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 L. Hunsaker, in her 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.

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 variable interest 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 a former subsidiary, after it ceases to have a controlling interest in that subsidiary but is not able to exercise significant influence, 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>Value</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:

**Journal Entry**

<table>
<thead>
<tr>
<th>Description</th>
<th>Value (in $)</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 810-10-50-18, 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 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 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, in the absence of future standard setting, there may be diversity in practice regarding 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 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. 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 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.

  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.

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 consideration receivable</td>
<td>30</td>
<td></td>
</tr>
<tr>
<td>Total consideration</td>
<td>180</td>
<td>150</td>
</tr>
<tr>
<td>Less: subsidiary’s carrying amount</td>
<td>(100)</td>
<td>(100)</td>
</tr>
<tr>
<td>Initial gain on sale</td>
<td>$80</td>
<td>$50</td>
</tr>
</tbody>
</table>

F.4 Parent’s Disclosures Upon Deconsolidation of a Subsidiary

ASC 810-10-50-1B provides the following disclosure requirements for a parent that deconsolidates a subsidiary:

<table>
<thead>
<tr>
<th>ASC 810-10-50-1B</th>
</tr>
</thead>
<tbody>
<tr>
<td>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:</td>
</tr>
<tr>
<td>a. The amount of any gain or loss recognized in accordance with paragraph 810-10-40-5</td>
</tr>
<tr>
<td>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</td>
</tr>
<tr>
<td>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</td>
</tr>
<tr>
<td>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</td>
</tr>
<tr>
<td>e. Information that enables users of the parent’s financial statements to assess the inputs used to develop the fair value in item (d)</td>
</tr>
<tr>
<td>f. The nature of continuing involvement with the subsidiary or entity acquiring the group of assets after it has been deconsolidated or derecognized</td>
</tr>
<tr>
<td>g. Whether the transaction that resulted in the deconsolidation or derecognition was with a related party</td>
</tr>
<tr>
<td>h. Whether the former subsidiary or entity acquiring a group of assets will be a related party after deconsolidation.</td>
</tr>
</tbody>
</table>
Appendix G — Glossary of Standards and Other Literature

The following are the titles of standards and other literature mentioned in this publication:

**AcSEC Issues Paper**
*Joint Venture Accounting*

**AICPA Audit and Accounting Guide**
*State and Local Governments*

**AICPA Statements of Position (SOPs)**
90-7, *Financial Reporting by Entities in Reorganization Under the Bankruptcy Code*
78-9, *Accounting for Investments in Real Estate Ventures*

**FASB Accounting Standards Codification (ASC) Topics**
ASC 205, *Presentation of Financial Statements*
ASC 250, *Accounting Changes and Error Corrections*
ASC 310, *Receivables*
ASC 320, *Investments — Debt and 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 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 805, *Business Combinations*
ASC 810, *Consolidation*
ASC 815, *Derivatives and Hedging*
ASC 820, *Fair Value Measurement*
ASC 825, *Financial Instruments*
ASC 840, *Leases*
ASC 845, *Nonmonetary Transactions*
ASC 850, *Related Party Disclosures*
ASC 852, *Reorganizations*
ASC 855, *Subsequent Events*
Appendix G — Glossary of Standards and Other Literature

ASC 860, Transfers and Servicing
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 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 976, Real Estate — Retail Land

FASB Accounting Standards Updates (ASUs)
ASU 2015-02, Amendments to the Consolidation Analysis
ASU 2014-10, Elimination of Certain Financial Reporting Requirements, Including an Amendment to Variable Interest Entities Guidance in Topic 810, Consolidation
ASU 2014-07, Applying Variable Interest Entities Guidance to Common Control Leasing Arrangements
ASU 2014-01, Accounting for Investments in Qualified Affordable Housing Projects
ASU 2013-08, Financial Services — Investment Companies: Amendments to the Scope, Measurement, and Disclosure Requirements
ASU 2010-15, How Investments Held Through Separate Accounts Affect an Insurer’s Consolidation Analysis of Those Investments
ASU 2010-10, Amendments for Certain Investment Funds
ASU 2009-17, Improvements to Financial Reporting by Enterprises Involved With Variable Interest Entities

FASB Statements (Pre-Codification Literature)
No. 167, Amendments to FASB Interpretation No. 46(R)
No. 160, Noncontrolling Interests in Consolidated Financial Statements
No. 144, Accounting for the Impairment or Disposal of Long-Lived Assets
No. 142, Goodwill and Other Intangible Assets
No. 125, Accounting for Transfers and Servicing of Financial Assets and Extinguishment of Liabilities
No. 94, Consolidation of All Majority-Owned Subsidiaries
No. 57, Related Party Disclosures

FASB Concepts Statement (Pre-Codification Literature)
No. 7, Using Cash Flow Information and Present Value in Accounting Measurements

FASB Interpretations (Pre-Codification Literature)
Interpretation No. 46(R), Consolidation of Variable Interest Entities — an interpretation of ARB No. 51
Interpretation No. 46, Consolidation of Variable Interest Entities — an interpretation of ARB No. 51

EITF Issues (Pre-Codification Literature)
10-E, “Accounting for Deconsolidation of a Subsidiary That Is In-Substance Real Estate”
09-4, “Seller Accounting for Contingent Consideration”
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"
Appendix G — Glossary of Standards and Other Literature

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”
96-21, “Implementation Issues in Accounting for Leasing Transactions Involving Special-Purpose Entities”
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”
95-6, “Accounting by a Real Estate Investment Trust for an Investment in a Service Corporation”
Topic D-14, “Transactions Involving Special-Purpose Entities”

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No. 51, Consolidated Financial Statements

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Applicability of GASB Standards

G4+1 Organization Special Report
Reporting Interests in Joint Ventures and Similar Arrangements

SEC Regulation S-X
Rule 1-02, “Definitions of Terms Used in Regulation S-X”
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Rule 3-09, “Separate Financial Statements of Subsidiaries Not Consolidated and 50 Percent or Less Owned Persons”
Rule 3A-02, “Consolidated Financial Statements of the Registrant and Its Subsidiaries”
Rule 3-10, “Financial Statements of Guarantors and Issuers of Guaranteed Securities Registered or Being Registered”
Rule 4-08(g), “Summarized Financial Information of Subsidiaries Not Consolidated and 50 Percent or Less Owned Persons”
Rule 5-02, “Balance Sheets”
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SEC Investment Management Staff Guidance Update

SEC Staff Accounting Bulletin (SAB) Topic
SAB Topic 5.G, “Transfers of Nonmonetary Assets by Promoters or Shareholders”

International Standards
IFRS 12, Disclosure of Interests in Other Entities
IFRS 11, Joint Arrangements
IFRS 10, Consolidated Financial Statements
IFRS 9, Financial Instruments
IAS 28, Investments in Associates and Joint Ventures
IAS 27, Separate Financial Statements
# Appendix H — Abbreviations

<table>
<thead>
<tr>
<th>Abbreviation</th>
<th>Description</th>
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<tbody>
<tr>
<td>ABS</td>
<td>asset-backed security</td>
</tr>
<tr>
<td>AcSEC</td>
<td>Accounting Standards Executive Committee</td>
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<tr>
<td>AFS</td>
<td>available for sale</td>
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<tr>
<td>AICPA</td>
<td>American Institute of Certified Public Accountants</td>
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<tr>
<td>ARB</td>
<td>Accounting Research Bulletin</td>
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<tr>
<td>ASC</td>
<td>FASB Accounting Standards Codification</td>
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<tr>
<td>ASU</td>
<td>FASB Accounting Standards Update</td>
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<tr>
<td>CAQ</td>
<td>Center for Audit Quality</td>
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<tr>
<td>CDO</td>
<td>collateralized debt obligation</td>
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<tr>
<td>CEO</td>
<td>chief executive officer</td>
</tr>
<tr>
<td>CFE</td>
<td>collateralized financing entity</td>
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<tr>
<td>CFO</td>
<td>chief financial officer</td>
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<td>CICA</td>
<td>Canadian Institute of Chartered Accountants</td>
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<td>CIRA</td>
<td>common interest realty association</td>
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<tr>
<td>CLO</td>
<td>collateralized loan obligation</td>
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<td>CMV</td>
<td>collateralized manager vehicle</td>
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<td>CP</td>
<td>commercial paper</td>
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<td>EITF</td>
<td>Emerging Issues Task Force</td>
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<td>EPC</td>
<td>engineering, procurement, and construction</td>
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<td>FASB</td>
<td>Financial Accounting Standards Board</td>
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<td>FSP</td>
<td>FASB Staff Position</td>
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<td>FDA</td>
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<td>FIN</td>
<td>FASB Interpretation Number</td>
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<td>FVO</td>
<td>fair value option</td>
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<td>generally accepted accounting principles</td>
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<td>HTM</td>
<td>held to maturity</td>
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<td>IAS</td>
<td>International Accounting Standard</td>
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<td>IFRS</td>
<td>International Financial Reporting Standard</td>
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<td>IM</td>
<td>investment management</td>
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<td>IPR&amp;D</td>
<td>in-process research and development</td>
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<td>IRR</td>
<td>internal rate of return</td>
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<td>London Interbank Offered Rate</td>
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<td>LIHTC</td>
<td>low-income housing tax credit</td>
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<td>limited liability company</td>
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<td>MBS</td>
<td>mortgage-backed security</td>
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<td>MD&amp;A</td>
<td>Management’s Discussion and Analysis</td>
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<td>NFP</td>
<td>not-for-profit entity</td>
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<td>1940 Act</td>
<td>Investment Company Act of 1940</td>
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<td>OCA</td>
<td>SEC’s Office of the Chief Accountant</td>
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<td>O&amp;M</td>
<td>operation and management</td>
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<td>power and utilities</td>
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<td>PCAOB</td>
<td>Public Company Accounting Oversight Board</td>
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<td>PCC</td>
<td>Private Company Council</td>
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<td>PPA</td>
<td>power purchase agreement</td>
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<td>PURPA</td>
<td>Public Utility Regulatory Policies Act</td>
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<td>Abbreviation</td>
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<td>R&amp;D</td>
<td>research and development</td>
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<td>REIT</td>
<td>real estate investment trust</td>
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<td>renewable energy credit</td>
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<td>Re-REMIC</td>
<td>resecuritization of real estate mortgage conduits</td>
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<td>SAB</td>
<td>SEC Staff Accounting Bulletin</td>
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<td>SEC</td>
<td>Securities and Exchange Commission</td>
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