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On the Radar

Consolidation — Identifying a Controlling Financial Interest

Under U.S. GAAP, there are two primary consolidation models: (1) the voting interest entity model and (2) the variable interest entity (VIE) model. Both require the reporting entity to identify whether it has a "controlling financial interest" in a legal entity and must therefore 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.

Consolidation conclusions (and related disclosures) under the VIE model can be different from those under the voting interest entity model. Therefore, reporting entities must first determine which model to apply.

Determining Which Consolidation Model to Apply

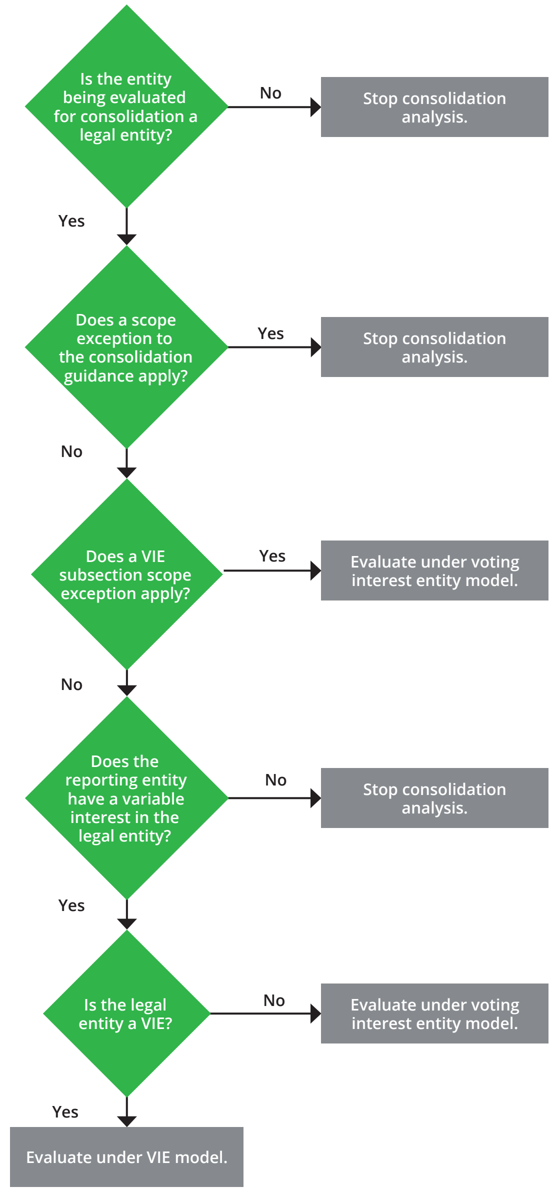
The adjacent flowchart illustrates the relevant questions a reporting entity should ask when determining which consolidation model to apply.

As depicted in the flowchart, the reporting entity must first assess whether the entity being evaluated is a legal entity and then whether there is a scope exception under which the reporting entity is exempt from applying either (1) the consolidation guidance in ASC 810 in its entirety or (2) the VIE model specifically. If no scope exceptions apply, the reporting entity must identify whether it holds a variable interest in the legal entity being evaluated for consolidation.

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 legal entity's performance. However, there are additional considerations for more complex arrangements (e.g., derivatives, leases, and decision-maker and other service-provider contracts).

If the reporting entity holds a variable interest in a legal entity, and no scope exception is met, it assesses whether the legal entity is a VIE by considering if the following conditions exist:

- 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 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.



While ASC 810 provides several conditions to consider in the VIE assessment, the legal entity must meet only one of these conditions to be a VIE.

The determination of whether a legal entity is a VIE ultimately governs the consolidation model the reporting entity must apply. If the legal entity is a VIE, the reporting entity uses the VIE model to assess whether to consolidate; otherwise, it uses the voting interest entity model.

Differences Between the Consolidation Models

Because the differences between a VIE and a voting interest entity may not always be evident, a reporting entity needs to understand all of the legal entity's contractual arrangements (explicit and implicit) as well as the legal entity's purpose and design. A "controlling financial interest" and "participating rights" are defined differently under each model, which highlights a fundamental distinction between the two models: to consolidate a legal entity under the voting interest entity model, the majority owner must have "absolute power" over all significant financial and operating decisions made in the ordinary course of business, whereas to consolidate a VIE under the VIE model, the reporting entity must have "relative power" over the activities that most significantly affect the VIE's economic performance.

Given that it is easier to demonstrate relative power over a legal entity than absolute power over it, the VIE model may result in consolidation more often than the voting interest entity model.

The most significant differences between the voting interest entity model and the VIE model are summarized in the table below.

Concept	Voting Interest Entity Model	VIE Model	Explanation
Definition of a controlling financial interest	The usual condition for consolidation is ownership of a majority voting interest or majority of the limited partnership's kick-out rights.	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 — or the right to receive benefits from — the entity that could potentially be significant to the entity.	Under either model, control may not rest with the majority owner if certain conditions exist. 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.
Definition of participating rights	Rights that allow the limited partners or noncontrolling shareholders to block or participate in certain significant financial and operating decisions that are made in the ordinary course of business. A majority voting interest holder is precluded from consolidating if a participating right that is held by a noncontrolling shareholder is related to any significant financial and operating decision that occurs as a part of the ordinary course of the investee's business.	Rights that 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. Participating rights only preclude another party from controlling and consolidating if they are 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.	While the definition of participating rights differs under the two models (i.e., under the VIE model, it encompasses a broader set of activities), the most significant difference is that the voting interest entity model precludes consolidation if a noncontrolling interest holder has a substantive participating right over **certain** significant financial and operating decisions. The VIE model precludes consolidation only if another party has substantive participating rights over **all** activities that most significantly affect the economic performance of the VIE.

(Table continued)

Concept	Voting Interest Entity Model	VIE Model	Explanation
Impact of related parties	Related parties and de facto agents are not considered.	Related parties, including de facto agents, must be considered. The identification of related parties can have a significant impact on the consolidation analysis, including potentially requiring one of the related parties to consolidate even though the reporting entity, on its own, does not have a controlling financial interest.	Related-party and de facto agency relationships may have an impact on the consolidation conclusion under the VIE model, whereas they have no impact under the voting interest entity model.
Disclosures	The required disclosures for consolidated subsidiaries are limited, including those about such subsidiaries that are not wholly owned.	In addition to the general disclosures required for consolidated voting interest entities, specific VIE disclosures about consolidated and unconsolidated VIEs must be provided.	Consolidating (or having a variable interest in) a VIE results in additional disclosure requirements.

FASB Project to Reorganize ASC 810; FASB Research Project

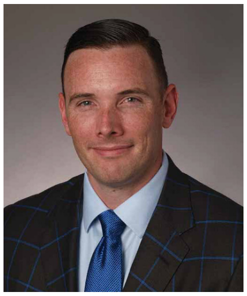
In 2016, the FASB added a project to its agenda to reorganize the guidance in ASC 810 into a new Codification topic, ASC 812. The Board undertook the project because, as currently organized, ASC 810 is difficult to navigate. Consequently, practitioners have often reorganized it within their interpretive guidance to facilitate its application. In addition, some stakeholders have indicated that certain terms and concepts in ASC 810 are overly complex and should be clarified.

During 2017, the FASB issued a proposed ASU, *Consolidation (Topic 812): Reorganization*, and received comments from stakeholders on the proposed guidance. Respondents generally supported the reorganization of ASC 810, but some noted that addressing other consolidation-specific projects (e.g., the development of a single consolidation model) might be more of a priority for the FASB.

The FASB decided in June 2018 to continue with the reorganization project and to publish nonauthoritative educational materials that focus on the more challenging parts of consolidation guidance and support and supplement the reorganized authoritative consolidation guidance. In June 2021, the Board issued an invitation to comment to request feedback on how to refine its broader standard-setting agenda. On the basis of feedback received, the FASB removed the reorganization project from its technical agenda in April 2022 and instead added a research project that will address whether a single consolidation model can be established for business entities.

For a comprehensive discussion of the accounting and financial reporting considerations related to applying the guidance in ASC 810, see Deloitte's Roadmap *Consolidation — Identifying a Controlling Financial Interest*.

Contacts



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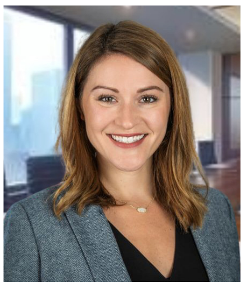

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